BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 705

COMPETITION IN THE RAILROAD INDUSTRY

229197

JOINT COMMENTS

of

ALLIANCE FOR RAIL COMPETITION, THE AMERICAN CHEMISTRY COUNCIL, AMERICAN FOREST AND PAPER ASSOCIATION, AMERICAN PUBLIC POWER ASSOCIATION, THE CHLORINE INSTITUTE, COLORADO WHEAT ADMINISTRATIVE COMMITTEE, CONSUMERS UNITED FOR RAIL EQUITY, EDISON ELECTRIC INSTITUTE, GLASS PRODUCERS TRANSPORTATION COUNCIL, IDAHO BARLEY COMMISSION, IDAHO WHEAT COMMISSION, KANSAS WHEAT COMMISSION, LARGE PUBLIC POWER COUNCIL, MONTANA FARMERS UNION, MONTANA WHEAT & BARLEY COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION, THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, NEBRASKA WHEAT BOARD, OKLAHOMA WHEAT COMMISSION, PORTLAND CEMENT ASSOCIATION, SOUTH DAKOTA WHEAT COMMISSION, TEXAS WHEAT PRODUCERS BOARD, THE FERTILIZER INSTITUTE, U.S. CLAY PRODUCERS TRAFFIC ASSOCIATION, AND WASHINGTON GRAIN COMMISSION

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The above-named parties, hereafter referred to as the "Interested Parties," hereby submit these Joint Comments in response to the Board's Notice in this proceeding served January 11, 2011. In that Notice, the Board indicated that it would be seeking written comments to explore the current state of competition in the railroad industry and possible policy alternatives to facilitate more competition, where appropriate. In its Notice, the Board presented the general background to its inquiry, and indicated that the proceeding was intended as a public forum "to discuss access and competition in the rail industry," with a view as to:

> what, if any, measures the Board can and should consider to modify its competitive access rules and policies; whether such modification would be appropriate given changes over the last 30 years in the transportation and shipping industry; the effects on rates and service these rules and policies

> have had; and the likely effects on rates and service of changes to these policies.[1]

The Board's Notice also set forth specific questions on various topics. The Interested Parties are submitting these Joint Comments to address topics and questions that the Board posed in its Notice. A number of the Interested Parties are also submitting individual comments on other topics and questions noted by the Board as well as related areas, in order to present the Board with a complete view of their positions in this matter.

The Interested Parties warmly applaud the Board for initiating this proceeding to inquire how the state of the railroad industry has changed since the current policies governing railroad competition were adopted. The Interested Parties strongly believe that the Board's competition policies are due for change.

The railroad industry typically attempts to portray any shipper effort on behalf of greater competition as seeking "re-regulation." This myth needs to be dispelled at the very outset. In fact, shippers seek real and meaningful deregulation so that free markets can flourish, in the same way that deregulation has resulted in a competitive revolution in the telecommunications industry and other industries.

As noted further in the body of these comments, comparing current railroad "deregulation" to that which has occurred in other industries shows how incomplete the current regime of railroad deregulation actually is. If the current rules applicable to railroad competition were applied in the telecommunications industry, for example, the result would be a system that few people would view as deregulation at all.

Suppose that after "Ma Bell" had been broken up into the "Baby Bells," each local Baby Bell had been left with the power to control local telephone switching and charge any price it

[1] *Competition in the Railroad Industry*, STB Ex Parte No. 705 at 5 (served Jan. 11., 2011).

wanted over the bottleneck local switching network. Consumers could use any long distance carrier they wanted, but in order to reach that long distance carrier, they would have to pay a monopoly rate which cancels out any cost advantage of using long distance carrier other than the local Baby Bell. That would be a situation that is directly analogous to the situation in which rail shippers find themselves. If this sort of "deregulation" had been imposed in the telecommunications industry, the public would be rightly outraged and the system would quickly be corrected. The fact of the matter is that, under the current system in the railroad industry, rail carriers have been given a license to engage in a degree of monopolization that would not be tolerated in any other industry.

As discussed in the body of these comments, the current agency rules on rail competition were frequently justified on the basis of the railroads' poor financial health. As shown below, railroads today are financially robust and do not need government subsidies in the form of a license to monopolize. Again, the telecommunications industry provides a close analogy. If railroad arguments about the harmful effects of competition were valid, the telecommunications industry (and trucking, natural gas pipelines, and other industries) would have withered on the vine following its thoroughgoing deregulation. Instead, capital investment and innovation in telecommunication has boomed and the total revenues of telecommunications companies have exploded as new products and services have been developed. The telecommunications industry as a whole has never been healthier.

The Interested Parties therefore strongly believe that it is time to enact policies implementing real deregulation of the railroad industry and real competition. The effective competition called for by Congress in the Rail Transportation Policy should deter railroads from abusing market power by raising rates and shifting costs to shippers, and should encourage railroads to improve service quality. Calls for regulatory and antitrust remedies will be reduced, and negotiated, private-sector resolutions will increase.

I. STATEMENTS OF INTEREST

The Interested Parties represent a broad array of industries with a strong interest in promoting competition within the rail industry as the principal means of achieving reasonable rail rates and service. Due to the large number of Interested Parties, the statements of interest for each party are presented separately in Exhibit A to these Comments. In addition, many of the Interested Parties have separately filed Comments in this proceeding to address issues specific to their industries.

II. THE CURRENT STATE OF RAIL COMPETITION

For rail dependent commodities, the current policies respecting rail economic regulation were premised on two fundamental assumptions that are no longer supportable: first, that competition in most cases would suffice to "regulate" rail rates; and second, that the supposedly woeful state of railroad finances and the railroads' supposedly unique capital investment needs justified the exercise of rail monopoly pricing power. As will be shown below, even if those premises were true when the Staggers Act was passed and subsequent regulatory decisions were made, they are no longer true today.

Although the Board and its predecessor approved the Burlington Northern/Santa Fe and Union Pacific/Southern Pacific mergers and the acquisition of Conrail by the Norfolk Southern and CSX (collectively the "mega-mergers") based in substantial part on the assurances by the applicants that the approved transactions would lead to healthy and vigorous rail-to-rail competition, the mega-mergers have in fact led to a substantial reduction of intramodal competition among the four surviving rail carriers notwithstanding the conditions designed to protect that competition that the Board's predecessor imposed. The surviving four rail carriers account for more than 90 percent of the rail revenues collected in the United States every year, and the absence of rail-to-rail competition threatens the economic well-being of entire segments of the U.S. economy. In view of the pro-competitive policies of the governing act, the Board is obligated to recognize these facts and act accordingly.

The remaining western carriers, the BNSF and the UP, have similar cost structures and offer largely standardized services. The same is true for NS and CSX in the east. The three mega-mergers happened within a three year time frame as did their respective oversight periods, a very brief period within which to assess the longer term consequences of such a dramatic change in the railroad market structure. Assuming the conclusions arrived at by the Board during the oversight periods were true when made — that is, intramodal competition among the surviving carriers was still in place and sometimes even vigorous — those competitive conditions have changed, as is detailed below.

Obviously, to the extent that any reduction in rail competition is the result of collusion, the courts under the applicable antitrust laws have jurisdiction and provide a potential means of redress. Some shippers have pursued such remedies, though other antitrust remedies are currently foreclosed to shippers, and too few short line railroads invoke antitrust remedies available to them. On the other hand, to the extent that a reduction in rail competition is the result of conscious parallelism, the Board has continuing jurisdiction under 49 U.S.C. § 11327 to remedy such anti-competitive conduct, and in the context of the merger proceedings here involved and the promises and representations made by the remaining rail carriers in those proceedings, conscious parallelism among the four dominant North American railroads is subject to the imposition of remedial conditions under 49 U.S.C. § 11327. And, as also detailed below, the Board also has authority to change its rules in order to further encourage rail-to- rail competition.

Laurits R. Christensen Associates, Inc., authors of the Board-commissioned study dated November 2009 and titled A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition[2] (the "Christensen Report"), arrived at several disturbing conclusions regarding the state of intramodal rail competition following these mergers. Among them is that the current duopoly market structures in the West with the BNSF and UP and in the East with the NS and CSX suggest conditions favorable for conscious parallelism. These are precisely the anti-competitive consequences that many, including the Department of Justice, predicted in their comments on the proposed mergers. The relatively short-lived period of apparent railroad rivalry following the mergers and during the merger oversight proceedings has been replaced by a dramatic reduction in competition and a corresponding dramatic increase in rail rates over the past seven years.

The Senate Commerce, Science, and Transportation Committee, Office of Oversight and Investigations Majority Staff Report of September 15, 2010 (the "Rockefeller Report")[3] sets forth a carefully researched and fully documented analysis of the current financial state of the four mega-merger survivors. The Rockefeller Report debunks the oft-repeated public relations position of the Association of American Railroads to the effect that the rail industry continues to struggle and has yet to reach financial viability. In fact, the Report documents the remarkable financial health of the big four railroads and their ability to price at levels that allow for double digit profit margins now and into the future.

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[2] Lauritis R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition* (rev. 2009), http://www.lrca.com/projects/railroadstudy/ [hereinafter *Christensen Competition Report*].

[3] Staff of S. Comm. on Commerce, Sci. & Transp., 111th Cong., *The Current Financial State of the Class I Freight Rail Industry* (2010) [herinafter *Rockefeller Report*]. This report is attached hereto as Exhibit B.

The Rockefeller Report details the contradictory financial stories told by the railroads. At the same time the railroads have complained to Congress and the Board that their financial returns do not justify capital investment, they have continued to provide rosy forecasts to their respective stock analysts emphasizing that investments in their stock will generate attractive returns. The Rockefeller Report goes on to recognize that a new reality exists with respect to the financial health of the railroads, a new reality of substantial profitability by any measure which belies railroad claims that they are a struggling industry and undermines the argument that giving the railroads a license to monopolize is still necessary. The Report concludes: "As Congress and the federal government look to the nation's rail system to meet the United States' future transportation needs, they also need to evaluate whether our country's current rail policy needs to be changed to reflect this new reality."[4]

The three mergers at issue were all justified and approved on the supposition that the remaining rail carriers would be strong "competitors" that would introduce additional competition into the relevant rail transportation markets. While the resulting combined railroads have undoubtedly become stronger economic entities, they have manifestly failed to introduce more rail-to-rail competition. In fact, the reverse is true.

A. The Board Premised Its Approval of Mergers on Future Vigorous Rail-to-Rail Competition.

The Board and its predecessor, the Interstate Commerce Commission ("ICC"), acknowledged the need to weigh the possible anti-competitive effects of proposed rail consolidations and to balance those possible negative effects against the claimed benefits flowing from the transactions. In conducting this balancing analysis, the Board and ICC historically

[4] *Id.* at 14.

recognized generally applicable antitrust principles.[5] The ICC restated those antitrust principles as they would apply in a railroad merger case in the BN/Santa Fe Merger decision: "The key test for competitive harm remains the same for both horizontal and vertical effects; will the merger result in increased rates or deteriorated service or both?"[6] That test was and is legally and economically sound. Any railroad merger that leads to increased rates and/or eliminates the competitive prod for service improvement cannot be held to be in the public interest.

In the UP/SP Merger decision,[7] the Board approved the second of the mega-mergers. This merger was actively opposed by the Department of Justice which predicted that the duopoly systems of the BNSF and the combined UP/SP would lead to a substantial reduction in competition between those systems, which would dominate the western United States.[8] The Board disagreed, holding that the merger would result in rivalry, not collusion.

The decline in price competition in the West did not happen immediately with approval of the two mega-mergers in that market. In its General Oversight decision of the UP/SP Merger, the Board observed that a study done by STB staff had shown that rail rates in the West had continued to decline in constant dollars from 1996 to 1999.[9] This and the absence of contrary evidence from any affected party led the Board to conclude that the head-to-head competition between BNSF and UP was producing significant competitive benefits, as it had predicted.

The Board was faced with yet another major merger when Norfolk Southern and CSX sought to acquire Conrail. Approval of this transaction would create a duopoly in the East

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[5] For example, in *Burlington Northern Inc. -- Control & Merger -- Sante Fe Pacific Corp.*, 10 I.C.C. 2d 661, 728 n.74 (1995), the ICC stated: "We accept as a starting point the definition of a market in the DOJ/ Federal Trade Commission's Horizontal Merger Guidelines, 57 FR 41552 (Sept. 10, 1992): 'a set of products or services within a geographic area for which a hypothetical monopolist could profitably impose a 'small but significant and nontransitory' price increase.'"
[6] *Burlington N. Inc. -- Control & Merger -- Sante Fe Pac. Corp.*, 10 I.C.C. 2d 661, 729 (1995).
[7] *Union Pac. Corp. -- Control & Merger -- S. Pac. Rail Corp.*, 1 S.T.B. 233 (1996).
[8] *See Id.* at 350.
[9] *Union Pac. Corp -- Control & Merger -- S. Pac. Rail Corp. (Gen. Oversight)*, 5 S.T.B. 388, 394 (2000)

matching that in the West. In its decision approving the transaction, the Board again predicted vigorous competition between NS and CSX, citing the "one-lump theory."[10] The Board held:

> With very minor exceptions, the combination of NS and Conrail and of CSX and Conrail lines will be end-to-end and not parallel. It has been our experience that end-to-end restructurings of this kind rarely result in a diminution of competition. We have adopted a presumption, known as the one-lump theory, that vertical combinations will not result in competitive harm. We have also established a test for parties to show that the theory does not apply in a particular circumstance. Although several parties have attempted to argue that we should not apply the one-lump theory to rail mergers, repeating arguments that have been raised and rejected in previous merger proceedings, no party has rebutted the application of the theory here. Our use of the one-lump theory has been judicially approved, and we will not go back over that ploughed ground here.[11]

In approving the Conrail acquisition the Board also noted, as it had in the UP/SP Merger decision, that rail rates had been declining since 1980 stating:

> [T]he clear trend since 1980 has been that railroad efficiencies achieved through mergers or other means have been largely passed along to shippers in the form of lower rates and improved service.
>
> Indeed, our monitoring of rail rates indicates that this downward trend has continued since 1993, a time during which rail service in the West was totally restructured with two major rail mergers.[12]

In its new Merger Guidelines adopted in June of 2001,[13] the Board first took notice of the competitive dangers presented by the increased size of rail carriers resulting from future mergers. The Board noted:

> As we noted in the NPR, shippers that are served by a single rail carrier may nevertheless benefit from the indirect competition that results from having another carrier nearby .... They also may benefit from the opportunity to negotiate a long-term contract

[10] *CSX Corp. – Control & Operating Leases/Agreements – Conrail Inc.*, 3 S.T.B. 196, 248 (1998).
[11] *Id.*(citation omitted).
[12] *Id.* at 249.
[13] *Major Rail Consolidation Procedures*, 5 S.T.B. 539 (2001) [herinafter *Merger Guidelines*].

> before choosing to locate a new plant along either of two carriers' lines or to adjust production levels at plants already located along those lines.[14]

The Board went on to conclude: "Thus, a merger between any two U.S. Class I rail carriers or between major U.S. and Canadian rail carriers would surely threaten certain shippers with a loss of some indirect competition."[15]

The Board also found that:

> Moreover, significant losses in geographic competition could occur even where carriers truly are "end-to-end," because there are many commodities (such as phosphate and soda ash) that have a limited number of sources. Similarly, a merger between BNSF and a Canadian carrier, even if largely end-to-end, could raise potential competitive concerns in western export wheat markets. End-to-end carriers that compete with each other geographically would stand to gain market power if we were to approve their merger without imposing effective conditions, which as discussed above, could be difficult.[16]

Notwithstanding the "one-lump theory," the Board was clearly concerned with the potential anti-competitive consequences of any future substantial merger, including an end-to-end merger of large carriers. The Board stated that while it had not *yet* seen anti-competitive consequences of the already approved mega-mergers, it did not exclude the possibility that diminished competition could occur in the future.[17] It noted in its new Merger Guidelines that:

> Since 1980 at least, we have consistently imposed merger conditions to preserve two-railroad service where it existed, and we have imposed remedies to preserve competition where the number of carriers serving a shipper has gone from three to two in limited circumstances on a case-by-case basis. The overall result, <u>so far</u>, has been that railroads have continued to face effective competition either from other railroads or other modes, that has forced them to pass on the preponderance of the significant

[14] *Id.* at 556.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 548.

> efficiency gains they have achieved (through mergers and other means) to the shippers that they serve.[18]

Assuming the Board's observations regarding the state of rail to rail competition were accurate when made, things were about to change and change dramatically.

B. Competitive Circumstances Have Changed Since the Approval of the Major Mergers

In its most recent study of rail rates, the Board's Office of Economics, Environmental Analysis & Administration, Section of Economics found that:

> [I]nflation-adjusted rail rates increased in 2005, 2006 and 2007. This represents a significant change from prior years, given that inflation-adjusted rail rates declined in every year but one from 1985 through 2004. Since 2004, however, rail rates have increased. In fact, adjusting for the purchasing power of the dollar, shippers spent $7.8 billion more in 2007 than they would have if rate levels of 2004 had remained in place.[19]

The Study attributes this rate increase to several factors including increased fuel costs, but concludes: "Nevertheless, even after factoring out rising fuel costs, railroad rates have risen in the last three years after falling for decades."[20]

The Section of Economics Study is not limited to the four surviving dominant railroads in the United States, but includes all Class I as well as Class II and Class III carriers. However, when the economic indicators are limited to the four major railroads an even more compelling story is told. As the Rockefeller Report documents, the big four carriers had a "profit margin" or "return on revenue" of 7% in 2004, which jumped to 12% in 2005 and was 12.6% in 2008.[21] This 2008 profit margin placed the big four among the top five of the 53 industries on *Fortune's*

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[18] *Id.* at 548-49 (emhasis added) (footnotes omitted).
[19] Section of Econ., Surface Transp. Bd., *Study of Railroad Rates: 1985-2007* 1 (2009).
[20] *Id.* at 2. In the new Merger Guideline Decision, the Board noted: "The most recent OEEAA study shows that since 1984, inflation-adjusted railroad rates have decreased more than 45%. As Norfolk Southern...observes, substantial decreases do not occur in the absence of competition." *Merger Guidelines*, 5 S.T.B at 549 n.11. NS might also have added that substantial increases do not occur in the presence of competition.
[21] *Rockefeller Report, supra* note 3, at 4-5.

list of most profitable industries.[22] Similarly, in 2004 the big four had a combined operating ratio of 84.6%, which dropped to 75.9% by 2009[23] — an astounding reduction in costs versus revenues, particularly when fuel prices, a major element of cost, were rising. This is highly significant, because just as price reductions are unlikely to occur in the absence of competition, rapid escalations of prices over costs rarely occur if meaningful competition is present. Notably, whereas companies in highly competitive industries are often unable to pass rapidly escalating costs through to customers, the big four railroads were able to take advantage of the lack of competition among them to *over-recover* their fuel costs since 2004 by imposing parallel fuel surcharges. Submissions in Ex Parte No. 661, Rail Fuel Surcharges, documented that, in contrast to transparent and negotiated fuel surcharges assessed by carriers of other modes, the fuel surcharges imposed by the major railroads were offered on a "take it or leave it" basis not subject to any meaningful negotiation.[24]

In the Christensen Report, the authors noted:

> The similarity of cost structures can have implications for the competitive behavior of the railroad industry. BNSF and UP are about equal-sized railroads and dominate the industry in the western U.S. Likewise, CSX and NS are about the same size and dominate the eastern corridor freight traffic. In fact, many of the shippers we interviewed suggested that the U.S. railroad industry functions like two duopolies. Theories of oligopoly suggest that parallel behavior (whether coordinated or not) is more likely in situations where the industry has only a few firms each offering a fairly standard product and facing similar cost structure. Our cost analysis indicates that BNSF and UP face similar cost structures, and the same is true for CSX and NS. In particular, the similarities in marginal cost, because of its fundamental relationship to price, suggest conditions favorable for parallelism.[25]

[22] Fortune, *Fortune 500 Top Performers: Most Profitable Industries 2009*, http://money.cnn.com/magazines/fortune/fortune500/2009/performers/industries/profits/ (last visited April 11, 2011).
[23] *Rockefeller Report*, *supra* note 3, at 6.
[24] *See, e.g.*, Comments of Alliance of Auto. Mfrs. at 3, *Rail Fuel Surcharges*, STB Ex Parte No. 661 (Apr. 27, 2006); written testimony of Mittal Steel at 5-6, *Rail Fuel Surcharges*, STB Ex Parte No. 661 (Apr. 27, 2006).
[25] 3 *Christensen Competition Report*, *supra* note 2, at 9-29 (emphasis added) (footnote omitted).

The Christensen Report was commissioned by the Board in response to a recommendation in the Government Accountability Office's 2006 Report on the state of the rail freight industry. While the GAO Report was based on data assembled before the most dramatic rise in rail freight rates, it nevertheless noted the beginnings of a reversal in the downward trend in rates since passage of the Staggers Act. The fundamental thrust of the Christensen Report was to identify why things had changed in the railroad transportation market, including whether increased railroad market power or other economic factors caused the changes. The report noted that not only were prices rising for the first time in decades, but also that productivity was declining for the first time in decades for reasons that the Christensen Associates could not explain. In short, while the Christensen Report did answer some questions and offer some possible explanations, it did not really explain what was going on in the railroad industry or why. As the trends continued, however, it became clear that both the price increases and productivity declines were traceable to a common cause – a lessening of rail-to-rail competition caused by collusion and/or conscious parallelism among the big four railroads.

The present ability of the big four to increase prices and maintain those price increases even in the face of a substantial economic downturn is an undeniable fact. The current absence of rail-to-rail competition in the duopoly markets of the eastern and western United States is largely responsible for this new found pricing ability, often referred to as the "railroad pricing renaissance." This new pricing freedom is not what the merger applicants promised or what the Board or ICC anticipated in approving the mergers that gave rise to this removal of rail-to-rail competition. The constantly repeated refrain from the applicants was that the involved mergers would allow for greater competition, better service, and improved productivity. Instead, a substantial move toward conscious parallelism with flat or declining productivity and rising prices has occurred. Now that the true impact of the mega-mergers is plain for all to see, it is time for the Board to reconsider its past decisions and policies regarding implementation of the competition enhancing provisions of the Staggers Act and how it balances the competing rail transportation policies of railroad revenue adequacy and enhanced competition.

III. TODAY'S RAIL INDUSTRY IS FINANCIALLY HEALTHY

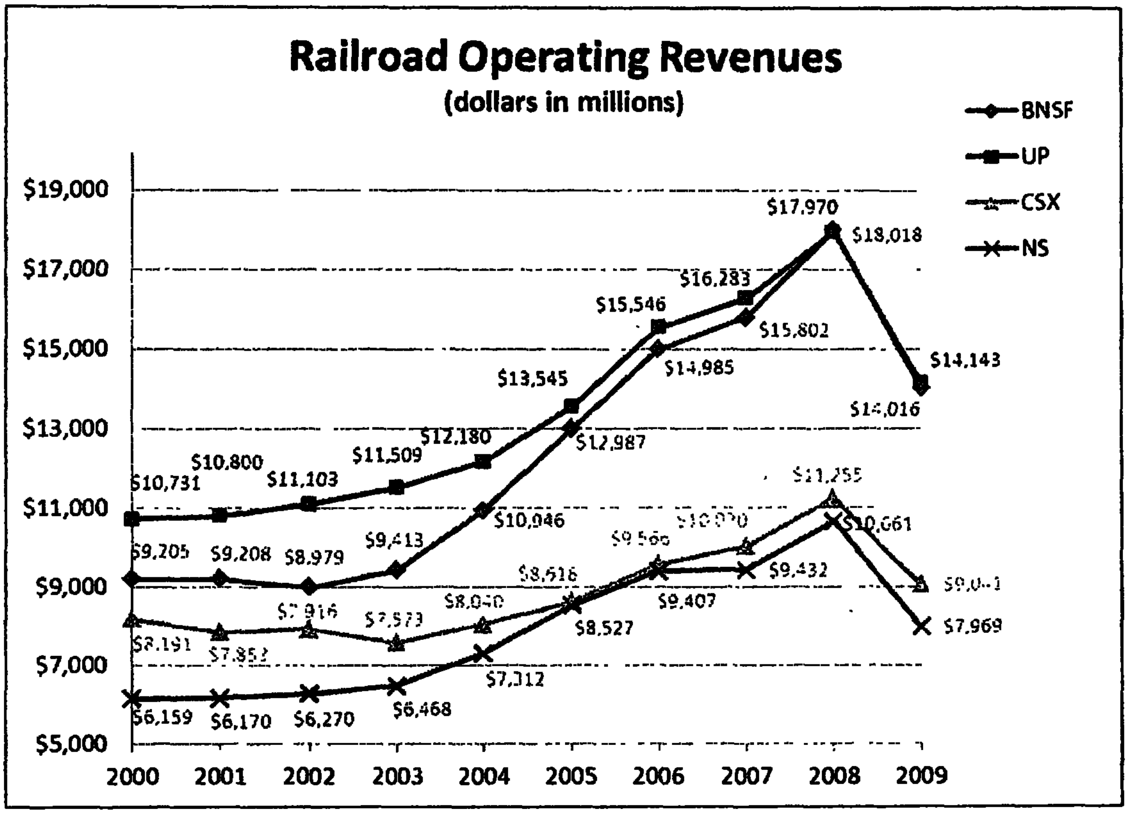
It is clear that the current financial state of the railroad industry is strong. For example, as is documented in the Senate Commerce Committee Report noted above, the big four carriers had a "profit margin" or "return on revenue" of 7% in 2004, which jumped to 12% in 2005, and was 12.6% in 2008.[26] As noted above, this 2008 profit margin placed the big four rail carriers among the top five of the 53 industries on *Fortune's* list of most profitable industries.[27] Similarly, from 2004 to 2009, the four largest rail carriers' combined operating ratio had decreased significantly from 85% to 75.9%,[28] which was all the more significant because fuel prices, a major element of cost, were rising.

The Senate Commerce Committee Report demonstrates that the rail industry is not the struggling and economically challenged group of disparate competitors that it was when the Staggers Act was passed. It is not the high-risk and low-return investment that scared Wall Street away during the 1980s and 1990s. It is a booming financial machine that has used its considerable market power to raise prices and create one of the healthiest industries in the United States.

[26] *Rockefeller Report, supra* note 3, at 4-5.
[27] Fortune, *Fortune 500 Top Performers: Most Profitable Industries*, http://money.cnn.com/magazines/fortune/fortune500/2009/performers/industries/profits/ (last visited April 11, 2011).
[28] *Rockefeller Report, supra* note 3, at 6.

As demonstrated by Figure I below,[29] the consolidated operating revenues of the big four U.S. railroads increased from $34 billion in 2000 to $58 billion in 2008, before greatly reduced traffic volumes lowered operating revenues to $45 billion in 2009.[30]

Figure I



At the same time, Figure II in conjunction with Figure I shows that, while operating revenues rose dramatically from 2004 to 2008 and then dropped in 2009, net profits rose even more dramatically to nearly double from 7.15% in 2004 to 13.24% in 2008 and declined only slightly in 2009 to 12.82% in 2009. Rising profits in the face of declining traffic volumes of this

[29] Figures I, II and III are derived from the 10K Reports filed by the big four railroads with the Securities and Exchange Commission.

[30] Figure I not only shows that operating revenues increased from 2000 to 2009, it also shows that the carriers operating in the two duopolies in the West and in the East had revenues that increased in virtual lockstep. This is not the type of revenue growth that one would expect in a market where the participants were competing for market share.

magnitude can only be reasonably attributed to the highly touted "railroad pricing renaissance" of the post mega-merger era.

Figure II

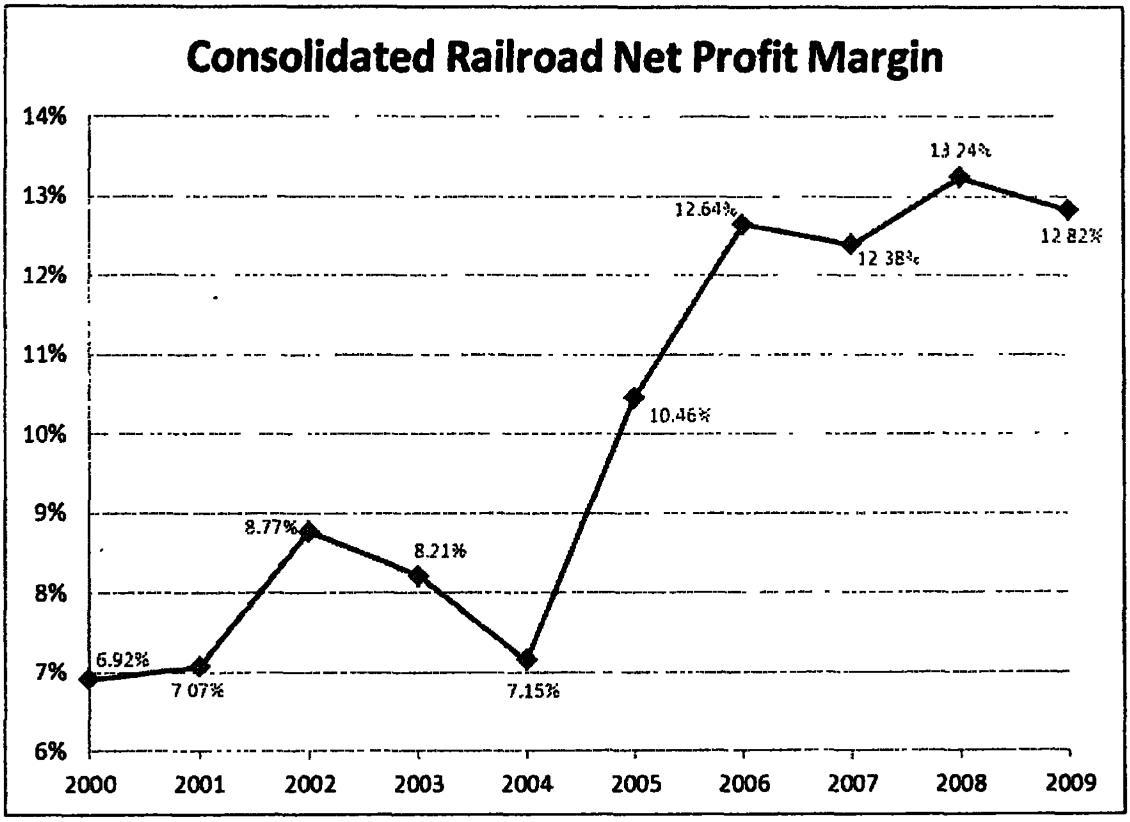
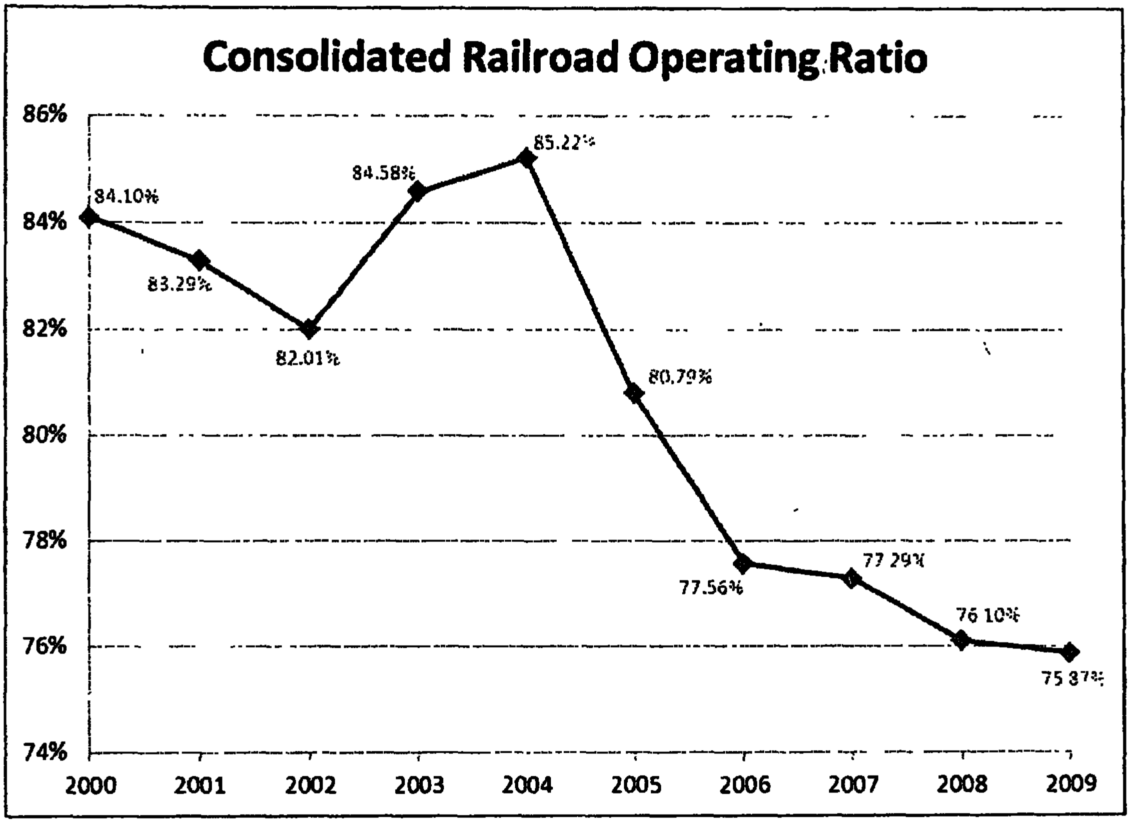


Figure III shows the combined operating ratio of the big four over the same time frame as shown in Figures I and II. As noted above, the remarkable decline in operating ratios is plainly not the result of any reduction in costs or increases in productivity.[31] Instead, it is the product of the substantial increases in railroad prices seen throughout the nation over this time period.

[31] The Christensen Report observes an unexplained but noticeable decline in the productivity beginning in 2003 and continuing through 2008.

Figure III



In view of these financial results, the answer to the question of the rail industry's financial health is, or ought to be, straight forward. The Class I railroad industry in general, led by the big four, is quite healthy and has been "revenue adequate" for some time.

The most obvious and most recent evidence of the railroad industry's financial health is Berkshire Hathaway's payment of an approximately $30/share premium over market price to acquire all of the BNSF. Berkshire Hathaway and its chairman, Warren Buffett, obviously believe that the BNSF will provide a more-than-adequate return for many years to come. This view was borne out by the most recently reported financial results for Berkshire Hathaway.[32]

[32] *See* United Transp. Union, *Railroad's 2010: How Sweet It Was*, Jan. 28, 2011, http://www.utu.org/worksite/detail_news.cfm?ArticleID=53856.

Indeed, Mr. Buffet's annual letter to shareholders dated February 26, 2011 stated that 2010 was a great year for Berkshire Hathaway in part because of its acquisition of BNSF:

> The highlight of 2010 was our acquisition of Burlington Northern Santa Fe, a purchase that's working out even better than I expected. It now appears that owning this railroad will increase Berkshire's "normal" earning power by nearly 40% pre-tax and by well over 30% after-tax. Making this purchase increased our share count by 6% and used $22 billion of cash. Since we've quickly replenished the cash, the economics of this transaction have turned out very well.[33]

In sum, it is clear that the Class I railroad industry is financially healthy.

IV. THE BOARD HAS JURISDICTION AND DISCRETION TO CHANGE ITS POLICIES TO FACILITATE RAIL-TO-RAIL COMPETITION

In its decision initiating this proceeding, the Board urged the parties to focus their comments and testimony on seven separately-identified topics.[34] In the first topic, discussed immediately above, the Board asked parties to comment on the evolving economic state of the rail industry. The next four topics identified four different statutory provisions or areas of transportation law, including: (a) 49 U.S.C. § 10705, alternative through routes; (b) 49 U.S.C. § 11102(a), terminal facilities access; 49 U.S.C. § 11102(c), reciprocal switching agreements; and, (d) bottleneck rates. For each of these four topics, the Board asked, *inter alia,* "how to construe" the identified provision of the statute; what was "pre-Staggers Act practice" and "Staggers' effect on this issue"; and, most importantly, "whether there are statutory constraints on the Board's ability to change its policy at this time" or (in the case of the Bottleneck Issue) "whether the Board could and should change its precedent . . . ."[35]

[33] Letter from Warren Buffett, Chairman, Berkshire Hathaway, to Shareholders 3 (Feb 26, 2011), *available at* http://www.berkshirehathaway.com/letters/2010ltr.pdf.
[34] *Competition in the Railroad Industry*, STB EX PARTE NO. 705 at 6-7 (served Jan. 11., 2011).
[35] *Id.*

In this section, the Interested Parties discuss these areas of law and respond to the questions asked by the Board, including pre-Staggers Act practice, the effect of Staggers, and the issue of whether there are statutory or other legal constraints on the Board's ability to change its policy. These areas of law will be dealt with under the following three headings: (a) Reciprocal Switching Agreements under 49 U.S.C. § 11102(c); (b) Terminal Facilities Access under 49 U.S.C. § 11102(a); and (c) Bottleneck Rates. The Interested Parties believe that, in each case, the Board has wide discretion under the statute to change its policies, and that there are no statutory or other legal constraints that would prevent the Board from changing its current rules and policies.

Of course, even new more pro-competitive policies cannot prevent all abuses of market power because some shippers are too far from a competing railroad to benefit from competitive remedies, and because railroads that could compete do not always do so effectively. For such shippers, the Board must continue, and strengthen, its regulation of unreasonable rail rates and practices.

A. THE BOARD HAS BROAD DISCRETION TO REVISE ITS POLICIES TO ENCOURAGE THE USE OF RECIPROCAL SWITCHING

Current § 11102(c) on reciprocal switching, which was added by section 223 of the Staggers Act,[36] provides that the Board "may require rail carriers to enter into reciprocal switching agreements, where it finds such agreements to be practicable and in the public interest, or where such agreements are necessary to provide competitive rail service." The language and legislative history of this section indicate that Congress, through this provision, substantially *broadened* the agency's power to establish reciprocal switching arrangements in order to

[36] Section 223 of the Staggers Act added this section as 49 U.S.C. §11103(c). ICC Termination Act of 1995 revised the number to 49 U.S.C. § 11102(c). Unless the context otherwise requires, the statutory provision in 49 U.S.C. added by Section 223 of the Staggers Act will be referred to by its current numbering as 49 U.S.C. § 11102(c).

encourage the development of such arrangements. Ironically, the agency's current rules and precedent, far from advancing that policy and encouraging reciprocal switching, have instead erected insuperable barriers to the use of section 11102(c). Indeed, the Board's policies and precedent are so unfavorable to shippers, that not a single shipper has even *filed* a request for reciprocal switching under the statute since the Board's last pronouncement regarding the standards that it will apply to establish reciprocal switching agreements under section 11102(c), fifteen years ago.

Fortunately, however, the Board is free to change its current policy and practice, since the statutory wording, legislative history and precedent involving § 11102(c) all indicate that the Board has very substantial discretion to determine the conditions under which reciprocal switching may be established. General court precedent also gives agencies, including the Board, substantial discretion to interpret their statute in light of changed conditions and new policies. Moreover, Congress' passage of the ICC Termination Act of 1995 ("ICCTA") does not constrain the agency's discretion. Although the Board need not rely on changes in the transportation market in order to initiate a revision of its policies and precedent in the area of reciprocal switching, in addition to the matters discussed in Sections II and III of these Joint Comments, there have in fact been changed circumstances related specifically to reciprocal switching that warrant a revision to the Board's rules and precedent. Finally, the Interested Parties strongly believe that the broad "practicable and in the public interest" standard cannot and should not be constrained by the "where . . . necessary to provide competitive rail service" standard. In other words, the two standards are independent, alternative tests.

1. The statutory language and legislative history of § 11102(c) indicate that Congress intended the agency to broaden the use of reciprocal switching and that congress gave the agency wide discretion to do so

Prior to the Staggers Act of 1980, the authority of the Interstate Commerce Commission ("ICC") to impose reciprocal switching arrangements upon carriers or to decide the terms and conditions of reciprocal switching arrangements was not clear.[37] In adding a provision on reciprocal switching to the legislation that eventually became the Staggers Act, Congress indicated that reciprocal switching was to be a *pro-competitive* benefit for shippers. The Staggers Act Senate Report noted, for example, that "[i]n areas where reciprocal switching is feasible, it provides an avenue of relief for shippers served by only one railroad where service is inadequate."[38] This same language was repeated by the Staggers Act Conference Committee Report.[39]

The Congress, in clarifying the agency's authority to prescribe reciprocal switching, fully expected the agency to utilize its new power in a pro-competitive manner. The Staggers Act House Report, for example, noted that "[t]he Committee *intends for the Commission to permit and encourage reciprocal switching as a way to encourage greater competition.*"[40] Accordingly, the Conference Committee accepted the slightly broader version of the provision adopted by the House in incorporating section 223 in the bill that eventually became the Staggers Act. Indeed, the Staggers Act Conference Committee Report *specifically* noted that the reciprocal switching agreement provision in the Act, among others, was "included to foster greater competition."[41]

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[37] *See*, S. Rep. No. 96-470, at 42 (1979); H.R. Rep. No. 96-1035, at 67 (1980).
[38] S. Rep. No. 96-470, at 42 (1979).
[39] H.R. Rep. No. 96-1430, at 116 (1980) (Conf. Rep.).
[40] H.R. Rep. No. 96-1035, at 67 (1980) (emphasis added).
[41] H.R. Rep. No. 96-1430, at 80 (1980) (Conf. Rep.). *See also, Central States Enters., Inc. v. ICC*, 780 F.2d 664, 679 (7th Cir. 1985) ("The purpose of the Staggers Act was to encourage, under the appropriate circumstances, but not require, the Commission to approve railroad switching agreements.").

On its face, the wording of the statutory provision gives the agency wide discretion to determine how to provide for broadened reciprocal switching. The language of the provision indicates that the Board "may" require carriers to enter into reciprocal switching arrangements under two standards: (a) where the agency "finds" such agreements to be "practicable and in the public interest"; or (b) where the agency finds that such agreements are "necessary to provide competitive rail service." All of this wording underscores the Board's discretion: the use of the discretionary term "may"; the broad requirement for "findings" determined solely by the Board; the use of the broad "public interest" standard as one alternative to establishing reciprocal switching; and an alternative standard in which the Board could find simply that it is "necessary" to provide competitive rail service.

Congress used the word "may" in this statute to indicate the Board has broad discretion to require reciprocal switching agreements. Courts have noted that the words of section 11102(c) give the agency wide discretion. In *Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988) ("*Midtec Court Review Decision*"), the court noted the "permissive" language of the reciprocal switching provision as embodied in the use of the word "may," and indicated that the statute "was cast in discretionary terms."[42] More generally, the United States Supreme Court has noted that the use of the term "may" "usually implies some degree of discretion."[43]

Here, the legislative intent behind § 11103(c)(2) and the statutory landscape support the implication that the Board has discretion. First, Congress intended to broaden the Board's regulatory power with § 11102(c)(2), clarifying the Commission's authority to order reciprocal switching[44] and expanding the Commission's ability to "permit and *encourage* reciprocal

[42] *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1499 (D.C. Cir. 1988).
[43] *United States v. Rodgers*, 461 U.S. 677, 706 (1983).
[44] *Baltimore Gas & Elec. Co. v. United States*, 817 F.2d 108, 113 (D.C. Cir. 1987) [hereinafter *BG&E*].

switching as a way to encourage greater competition."[45] Second, the broader purpose of the statutes governing rail transportation — to achieve the goals of the national rail transportation policy[46] — suggests that Board has discretion because it requires the Board to weigh multiple, competing factors when regulating the railroad industry.

Similarly, the "public interest" standard of § 11102(c)(2) invites the Board to use its discretion. Congress did not define "public interest," leaving the definition to the Board. In situations like this — where a statute is silent or ambiguous — the Board has broad discretion to resolve the ambiguity.[47] The only limit on this discretion is that it must "represent[] a reasonable accomodation of the conflicting policies that were committed to the agency's care by the statute."[48] Thus, the D.C. Circuit has upheld Commission determinations of public interest under § 11102(c)(2) that were reasonable in light of the national rail transportation policy.[49] Accordingly, the Board's discretion is reviewed under the broad standard of reasonableness.

Likewise, the same broad standard confines the Board's discretion to determine what is "necessary to provide competitive rail service." Congress directed the Board to determine necessity but did not provide clear guidance. To resolve the ambiguity, the Board may construe the provision in any manner that is reasonable.[50]

The wording of §11102(c) gives no indication beyond the broad "public interest/practicable" and "necessary to provide competitive rail service" standards as to how the reciprocal switching provision is to be construed, nor does the legislative history of §11102(c) give any firm direction. The matter is up to the agency's discretion, within the confines,

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[45] Staggers Act House Report, at 67 (1980) (emphasis added).
[46] 49 U.S.C. § 10101 (establishing the policy of the U.S. in regulating the railroad industry).
[47] *See Chevron U.S.A., Inc. v. Natural Res. Def. Council*, 467 U.S. 837, 844 (1984).
[48] *Id.*
[49] *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1501 (D.C. Cir. 1988); *BG&E*, 817 F.2d at 115.
[50] *Chevron*, 467 U.S. at 844.

however, of the pro-competitive purpose of the provision. The Staggers Act Senate Report simply noted that the "practicable and in the public interest" standard was the "same standard the Commission has applied for many years in considering whether to order the joint use of terminal facilities" under current 49 U.S.C. § 11102(a) (then 49 U.S.C. § 11103(a)). As discussed further in Section IV.B. of these Joint Comments, a review of the precedent under the joint use of terminal provisions reveals that the agency's standard had for many years been a broad one.

2. <u>In its decision in *D & H Railway Company*[51] just after the Staggers Act, the Board established reciprocal switching under a broad reading of the statutory provisions, indicating that the Board's current restrictive rules and precedent can be changed</u>

Just six months after the passage of the Staggers Act, the Delaware and Hudson Railway Company ("D&H") filed a petition under the newly-enacted reciprocal switching provisions of 49 U.S.C. 11103(c), seeking the imposition of a reciprocal switching agreement between the D&H and Consolidated Rail Corporation ("Conrail") covering rail service within the city of Philadelphia.[52] In its decision, the ICC noted that relief could be granted under <u>either</u> the "practicable/public interest" test or the "necessary to provide competitive rail service" test.[53]

In determining what is "practicable and in the public interest," the Board noted the broad standard that it had relied on in *Jamestown, N.Y. C. of C. v. Jamestown, W & N. R. R. Co.*, 195 I.C.C.289, 292 (1933) ("*Jamestown*"), and affirmed a finding by the Commission's Review Board that there are four broad criteria for determining whether the proposed switching service is "practicable and in the public interest": (1) the interchange and switching must be feasible; (2) the terminal facilities must be able to accommodate the traffic of both competing carriers; (3) the presence of reciprocal switching must not unduly hamper the ability of either carrier to serve its

[51] *Delaware and Hudson Railway Company v. Consolidated Rail Corporation – Reciprocal Switching Agreement*, 367 I.C.C. 718 (1981)
[52] *Id.*
[53] *Id.* at 720.

shippers; and (4) the benefits to shippers from improved service or reduced rates must outweigh detriments, if any, to either carrier. In *D&H*, the agency found that each of these four tests were met.[54] Significantly, the carrier did <u>not</u> dispute the propriety of the agency's criteria, only the application of the criteria. In determining the "public interest," the agency noted that "[a]dditional rail competition is a clear public benefit from the proposed operation, one which is endorsed by rail transportation policy announced in the Staggers Act."[55]

In finding that the petition met the second alternative test of "necessary to provide competitive rail service," the agency considered <u>only</u> intramodal rail competition in making that determination. In doing so, it rejected Conrail's arguments that the Review Board erred in failing to consider other types of competition in determining whether reciprocal switching was "necessary to provide competitive rail service." Conrail argued that the Review Board's standard would lead to the "unreasonable result that a competing carrier will be able to impose a reciprocal switching agreement on serving carriers in every instance where a particular shipper or group of shippers has access to only one carrier."[56] In rejecting the railroad's argument, the ICC declared:

> We affirm the review board's interpretation of the intramodal analysis under the "necessary competitive rail service" test. The clear language and legislative history of section 11103(c) show that it was Congress' intent that we focus on rail-to-rail competition in determining whether reciprocal switching agreements are necessary to provide competitive rail service. As noted by the [review] board in the prior decision, 366 I.C.C. at p. 854, the Senate Report (S. Rept. 96-470, 96th Cong. 1st sess. (1979) accompanying section 203(b) of Senate Bill S. 1946, the forerunner of what ultimately added section 11103(c), states that:
>
> > The new railroad transportation policy established by this bill emphasizes the need for increased intramodal and intermodal

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[54] *Id.* at 721-725.
[55] *Id.* at 723 (citing the Staggers Act policy to encourage competition).
[56] *Id.* at 727.

> competition and section 203 deals with intramodal competition among railroads.
>
> The [review] board's decision is consistent with the legislative history of section 11103(c).[57]

The ICC further noted that "[t]he reciprocal switching section is concerned with *increasing rail competition by authorizing an increase in the absolute number of rail carriers serving a particular market.* The legislative mandate of section 11103(c) thus requires a narrower (intramodal) focus in determining whether reciprocal switching is necessary to provide 'competitive rail service.'"[58] The agency concluded its analysis in the *D&H* decision by noting that "rail carriers have been given a great deal of flexibility to adjust their rates under the Staggers Act" and the agency was "convinced that Congress' aim in creating section 11103(c) of the Staggers Act was to *provide a competitive counterbalance* to this broadened rate freedom."[59] It buttressed this conviction by quoting the Conference Committee Report on the Staggers Act that "[a] number of provisions are included [in the Staggers Act] *to foster greater competition* by simplifying coordination, minor merger procedures, entry and *reciprocal switching agreements.*"[60]

Thus, three things are abundantly clear in examining the very first decision rendered by the ICC construing its new authority to order reciprocal switching under current § 11102(c): (1) the agency read the language and statutory history of the provision as requiring the agency to *encourage and facilitate* intramodal rail competition through the increased use of reciprocal switching; (2) the agency believed that an extremely broad test – one that would permit

[57] *Id.*
[58] *Id.* at 728 (emphasis added).
[59] *Id.* at 729 (emphasis added).
[60] *Id.* (first emphasis added and second emphasis in original) (citing H.R. Rept. 96-1430, at 80 (1980)). D&H subsequently sued Conrail under the antitrust laws for monopolization. *See Delaware & Hudson Ry. Co. v. Consolidated Rail Corp.*, 902 F.2d 174 (2d Cir. 1990) (reversing a trial court's grant of summary judgment in favor of Conrail).

reciprocal switching to be established in *every* case where a shipper was served by a single rail carrier – was consistent with the words and purpose of the statute; and, (3) the agency has broad authority and discretion to interpret § 11102(c). Thus, the *D&H* decision make abundantly clear that the Board has the authority *now* to change its current rules and precedent — rules and precedent that make it virtually impossible for any shipper to obtain reciprocal switching under the statute. It is to that subject that we now turn.

3. Board precedent construing its Ex Parte No. 445 competitive access rules with respect to reciprocal switching have effectively eliminated the possibility of establishing reciprocal switching under section 11102(c), a result inconsistent with the purpose of section 11102(c)

In the Staggers Act, shippers understood that regulation of railroads was to be curtailed, and instead, to the maximum extent possible, competition was to ensure that rail rates were reasonable. As discussed above, as a partial counterweight to the reduction in the regulatory regime, Congress decided that there should be a broadening of competitive access remedies by inserting new authority for the agency to establish reciprocal switching.

The Board's competitive access rules were promulgated in 1985.[61] Under the Board's rules in Ex Parte No. 445, the Board will establish a reciprocal switching arrangement only where necessary to remedy or prevent acts that are "contrary to the competition policies" of the statute or "otherwise anticompetitive."[62] One year later, the agency issued the first decision construing those rules in response to a request for reciprocal switching, in the case of *Midtec Paper Corp. v. Chicago & North Western Transportation Company*, 3 I.C.C.2d 171 (1986) [herinafter *Midtec*], *aff'd, Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988) (herinafter *Midtec Court Review Decision*). Between 1986 and 1996 the agency issued four

[61] See Ex Parte No. 445, *Intramodal Rail Competition*, 1 I.C.C.2d 822, *aff'd sub nom Baltimore Gas & Elec. Co. v. United States*, 817 F.2d 108, 114 (D.C. Cir. 1987).
[62] *See* 49 C.F.R. §1144.5(a)(1)(i).

decisions construing the agency's competitive access rules in response to requests for reciprocal switching or terminal trackage rights: (1) *Midtec*, including the *Midtec Court Review Decision*; (2) *Vista Chemical Co. v. Atchison, Topeka & Santa Fe Railway*, 5 I.C.C.2d 331 (1989); (3) *Shenango, Inc. v. Pittsburgh, C & Y Railway*, 5 I.C.C.2d 995 (1989), *aff'd sub nom. Shenango, Inc. v. ICC*, 904 F.2d 696 (3d Cir. 1990); and, (4) *Golden Cat Division of Ralston Purina Co. v. St. Louis Southwestern Railway*, ICC Docket No. 41550 (served Apr. 25, 1996) ("*Golden Cat*"). In each of these decisions, the agency refused to establish reciprocal switching or terminal trackage rights. More importantly, the precedents set by these decisions have for all practical purposes *eliminated* the availability of relief. Following is a brief review of only some of the statements and principles that have been stated in these decisions, that can be argued to govern reciprocal switching cases.

- The agency's competitive access rules are only intended to correct competitive abuse, only to prevent anticompetitive acts, and not to introduce additional competitive carrier service.[63] Relief is available only where there has been a demonstration of actual or threatened harm.[64]

- Whether or not "abuse" has occurred involves an antitrust-type inquiry.[65] The agency's competitive access rules narrow the agency's discretion under the statute to grant competitive remedies.[66]

- Under the statute, the agency must consider intramodal, intermodal and geographic competition.[67]

- Where the claim is that the carrier's rates are too high, a finding of market dominance is required, and there needs to be an inquiry into rate unreasonableness.[68] However, a finding of market dominance is not sufficient to justify a grant of competitive access.[69]

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[63] *Midtec*, 3 I.C.C.2d at 173-74; *see also*, *BG&E*, 817 F.2d at 114.
[64] *Vista Chemical*, 5 I.C.C.2d at 342.
[65] *Midtec*, 3 I.C.C.2d at 173-174.
[66] *Vista Chemical*, 5 I.C.C.2d at 335; see also, *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1500 (D.C. Cir. 1988).
[67] *Vista Chemical*, 5 I.C.C.2d at 336; *see also*, *Midtec Court Review Decision*, 857 F.2d at 1505, 1513.
[68] *Vista Chemical*, 5 I.C.C.2d at 336; see also, *Midtec Court Review Decision*, 857 F.2d at 1507.
[69] *Shenango, Inc. v. Pittsburgh, C & Y Railway*, 5 I.C.C.2d 995, 1001 (1989).

- A complete analysis of rates and costs is required to determine the relative efficiency of a carrier's route.[70]

- Even the charging of rates above Stand-Alone Cost is not a sufficient basis for the grant of competitive trackage rights.[71]

- The determination of whether a "terminal area" exists (a prerequisite to the grant of reciprocal switching or trackage rights) requires a full inquiry into the nature and use of the facility, including switching or classification activities, the activities of other shippers, and other facts.[72]

- To obtain competitive access on the basis of poor service, the fact that the carrier's service is not to the shipper's satisfaction is not enough; service failures have to be severe. The shipper must also demonstrate that the accessing carrier would not interfere with the landlord carrier's ability to handle its own business.[73]

The fact of the matter is that the above precedents currently present insuperable obstacles to a grant of competitive access relief through reciprocal switching. It can be argued that a shipper seeking such relief has to present evidence on: (1) likely or actual antitrust-type competitive abuse, such as market foreclosure, price squeezes, refusal to deal, or monopolization or predation; (2) market dominance, including intermodal, intramodal and geographic competition; (3) rate unreasonableness, including an inquiry into the carrier's costs and SAC; (4) the nature of the carrier's operations in the area to establish that there is a terminal area; and/or (5) severe service failures coupled with a showing that the operations of the carrier against whom relief is sought will not be impaired. Just the discovery requirements to adduce evidence to prove these elements are daunting. And because there has never been a successful case, no shipper can be sure of what, if any, evidence would ever satisfy the standards. In the face of all of this, shippers have been effectively deterred from even attempting to invoke the statutory

[70] *Vista Chemical*, 5 I.C.C.2d at 341.
[71] *Id.*
[72] *Golden Cat Div. of Ralston Purina Co. v. St. Louis Sw. Ry.*, ICC Docket No. 41550, slip op. at 7-8 (served Apr. 25, 1996).
[73] *Id.* at 9.

remedies. In the past fifteen years, there has not been even a single shipper application for reciprocal switching under § 11102(c).[74]

Although the ICC may have believed at the time that it published the Ex Parte No. 445 (Sub-No. 1) rules that it was simply "narrowing" the availability of relief under 49 U.S.C. § 11102(c), a review of all of the precedent reveals that the agency has, by erecting numerous legal and evidentiary barriers, in fact *foreclosed* any relief whatsoever. This result is fundamentally inconsistent with the purpose of the Congress in promulgating its new reciprocal switching remedy for shippers, and is fundamentally unfair. The Board can and should use the wide discretion given it to change its current rules on reciprocal switching.

4. Court review of the Board's decisions in Ex Parte No.445 and *Midtec* indicate that the Board has wide discretion in the area of reciprocal switching

The Interstate Commerce Commission's decisions in Ex Parte No. 445, *Intramodal Rail Competition*, and in *Midtec* were both appealed to the courts, the former in *BG&E* and the latter in the *Midtec Court Review Decision.* In both cases, the court affirmed the agency's decision. However, in both cases the court made clear that it was affirming the agency's decision *not* because the agency's interpretation was the only one permissible under the statute, but rather because the statute gave the agency discretion, and the agency's exercise of that discretion in the case at hand was properly explained. Thus, the court reviews of the agency's decisions make clear that the agency retains wide discretion under the statute, and that the agency's current policies are not the only ones possible.

In *BG&E*, the petitioner challenged as inconsistent with the statute the agency's decision to establish reciprocal switching arrangements *only* to remedy or prevent "anticompetitive" acts,

[74] Over ten years ago, the U.S. Court of Appeals for the Eighth Circuit noted that "invoking [the competitive access] rules has proved difficult for shippers . . . ." *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1108 (8th Cir. 1999).

as the ICC's Ex Parte No. 445 rules prescribed. The court noted that while BG&E's position might be a reasonable interpretation of the statute (a question the court did not decide), it was not the *only* reasonable interpretation because "the statutory directives under which the ICC operates do not all point in the same direction . . . Our task thus is only to determine whether the ICC has arrived at a reasonable accommodation of the conflicting policies set out in its governing statute . . . ."[75] In coming to that conclusion, the court noted "the Staggers Act's strong emphasis on preserving and enhancing competition . . . ." *Id.* Thus, the court was clear that, while the agency's interpretation of the statute set forth in its Ex Parte No. 445 rules was permissible, the agency might also come to some other permissible interpretation.

The same was true in the *Midtec Court Review Decision.* In that decision, the court noted the "permissive" language and "discretionary terms" of the statute. The court also noted that it would review the agency's "exercise of discretion" by examining whether it had provided a "reasoned analysis that is not manifestly contrary to the purposes of the legislation it administers."[76] The court found only that the agency's interpretation of the statute was a "reasonable accommodation" of the fifteen different and not-entirely-consistent goals of the national rail transportation policy set out in the Staggers Act, and saw "no basis in the text of the statute or in its legislative history for concluding that the Commission acted unreasonably. . . ."[77] Thus, it is abundantly clear that the court in the *Midtec Court Review Decision*, like the court in *BG&E*, recognized that §11102(c) did not mandate one result, but rather gave the agency wide discretion to interpret the provision in light of current circumstances and the need to weigh and balance the policies of the Act at a particular time. Thus, it is also abundantly clear from these court decisions specifically reviewing the agency's authority under §11102(c) that any future

[75] *Baltimore Gas & Elec. Co. v. United States*, 817 F.2d 108, 115 (D.C. Cir. 1987).
[76] *Midtec Paper Corp. v. United States*, 857 F.2d 1487, 1500 (D.C. Cir. 1988)
[77] *Id.* at 1501.

court, in reviewing any future change to the agency's rules and precedent on reciprocal switching, would review any such action under the same broad parameters.

5. In Ex Parte No. 575, the Board recognized that it had discretion to change its rules

As the Board's Notice indicates, Ex Parte No. 705 is not the first time that the Board has reviewed these issues. Specifically, the Board took extensive testimony and oral comments thirteen years ago, in Ex Parte No. 575, *Review of Rail Access in Competition Issues,* 3 S.T.B. 92 (1998) ("*Ex Parte No. 575 Decision*"). At the end of the proceeding, the Board noted that

> [T]he railroads have not satisfactorily addressed the shippers' basic complaints: that the rail industry has changed dramatically since 1980 as a result of significant railroad consolidations, system rationalizations, and greater carrier pricing flexibility and routing discretion. Although these changes have contributed to the efficiencies, cost savings, and improved earnings necessary to sustain the industry, cumulative the result has been a significantly more consolidated industry in which competitive options for rail-dependent shippers have not been expanded. This increasing consolidation within the industry, combined with the difficulties that many shippers perceive in obtaining relief through the regulatory system, leave too many shippers feeling that they have no leverage and no avenue of relief.[78]

Although ultimately the Board did not take action on the competitive access issues outlined in Ex Parte No. 575 (alternative through routes and bottlenecks, reciprocal switching, and terminal trackage rights),[79] the Board's observations about the negative effects of consolidation and constraints on competition are, for all of the reasons already mentioned, of more pressing concern today than they were thirteen years ago.

The Board's decision in Ex Parte No. 575 made clear that the Board believed that it had discretion to change its rules. The Board, for example, gave *no* indication that it believed that it was constrained by the statute from changing its policies in the three competitive access areas

[78] *Ex Parte No. 575 Decision,* 3 S.T.B. at 95.
[79] *See Ex Parte No. 575 Decision,* 3 S.T.B. at 97

that it discussed. On the contrary, the Board indicated that, "[t]o ensure that our procedures are effective in addressing needed service improvements, we will expeditiously begin a rulemaking proceeding to consider revisions to the competitive access regulations to address quality of service issues."[80] In addition, the Board indicated that "[g]iven the changes that have taken place in the rail industry since 1980, we will also consider whether to revise the competitive access rules with respect to competitive issues not related to quality of service."[81] The Board directed the railroads to arrange meetings with a broad range of shipper interests to explore the issue and see if the parties can mutually identify appropriate modifications to the non-service related component of the Board's competitive access standards that would "facilitate greater access where needed." The Board gave *no* indication that the statute would constrain changes in Board rules or policies or that the "meetings" would thus be restricted to statutory changes — indeed, the direct implication was that the Board would itself directly consider any changes recommended. Though nothing came of these discussions and the Board declined to go forward,[82] it was clear that the Board believed in 1998 that it had discretion to change its rules and policies.

6. Changed circumstance particularly warrant a revision to the Board's rules and precedent on reciprocal switching

As noted above, thirteen years ago, in Ex Parte No. 575, the Board declared that the railroads "have not satisfactorily addressed the shippers' basic complaints: that the rail industry has changed dramatically since 1980 as a result of significant railroad consolidations, system

[80] *Id.* at 98.
[81] *Id.*
[82] In a December 1998 letter to Congress, the STB reviewed its efforts in Ex Parte No. 575 and indicated that it would not reopen its competitive access rules because it believed that such a policy shift should be initiated by Congress rather than the agency. However, the agency's decision not to reopen was clearly made not because it believed that it did not have the statutory power to do so, but for reasons of comity and national policy.

rationalizations, and greater carrier pricing and routing discretion."[83] In the thirteen years since the Board's decision in 1998, there have been further changes in the industry, many of which have been discussed in Section II and III of these comments and which the Board has already noted in its Notice initiating this proceeding.[84] In addition, a few other changed circumstances should be discussed, pertaining specifically to reciprocal switching. Together with the changes already mentioned, such circumstances clearly warrant a revision to the Board's rules on reciprocal switching.

a. <u>Capacity constraints in the rail industry particularly justify a reexamination of the Board's rules on reciprocal switching</u>

There have been increasing concerns that the U.S. rail system is becoming or will soon become increasingly congested and may find it increasingly difficult to handle substantially increased volumes of traffic in the future, at least assuming that traffic rebounds from recession-induced volume reductions. According to the Department of Transportation, between 2010 and 2035, the U.S. transportation system will experience a 22 percent increase in the total tonnage that it moves, a result of population growth.[85] There is no question that traffic density on the U.S. rail system has increased very substantially since passage of the Staggers Act. According to the AAR, revenue ton-miles per owned mile of track has more than tripled since 1980, from 3.40 million ton-miles per owned mile of track to 11.06 million ton-miles per owned mile of track in

[83] *Ex Parte No. 575 Decision*, 3 S.T.B. at 95.
[84] *Competition in the Railroad Industry*, STB Ex Parte No. 705 at 3 (served Jan. 11., 2011).
[85] FRA, Dep't of Transp., *National Rail Plan* 6 (2010). It should be noted, however, that the Board-requested "Supplemental Report to the U.S. Surface Transportation Board on Capacity and Infrastructure Investment – Final Report," by Laurits R. Christensen Associates, Inc., March 2009 ["Christensen Capacity Report"], cautions that such long-term forecasts "should not be viewed as having a high degree of precision." *Id.*, at ES-4. Moreover, the Christensen Capacity Report cautions that DOT forecasts very high demand growth compared to current production forecasts from the Department of Energy and the Department of Agriculture for coal, petroleum products and grains, which are key components of the railroads' traffic mix. *See*, Christensen Capacity Report, at 5-1.

2008.[86] A recent study by RAND Supply Chain Policy Center ("Rand Study"), noted that "[r]ail traffic density may continue to increase, allowing for further productivity improvements, but recent indications that rates are rising suggest that it is possible that, at least in the near future, rail volumes may be approaching capacity."[87] The RAND Study also noted that current research from the finance industry suggests that rail rates have begun to increase by as much as 30 percent for some customers,[88] and indicated that several recent studies "strongly support the hypothesis that railroad prices are increasing rapidly."[89] As previously noted, DOT itself has indicated that between 2001 and 2008, rail rates increased over 25% in inflation-adjusted terms.[90] The RAND Study suggested that rail traffic density may now have increased to a level that could indicate that the rail industry, which is "clearly a natural monopoly," is facing capacity constraints.[91] The RAND Study also indicated that publicly available data suggests that decade-long improvements in rail speed and reliability "may be slowing or reversing,"[92] and that one study has noted that rail productivity metrics indicate that the rate of productivity increases in the rail industry began to decline in 2004.[93]

To the extent that the rail system is experiencing or will soon experience certain capacity constraints, particularly those constraints resulting from operations at specific choke points in the rail system, the increased use of reciprocal switching could provide additional efficiencies. Under the current system, if a shipper is served by a single rail carrier, even if another rail carrier is close by with an equally or even more-efficient routing from origin to destination, the shipper

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[86] Ass'n of Am. R.Rs., *Railroad Facts* 42 (2010). In 2009, revenue ton-miles per owned mile of track declined for the first time in 30 years because of the traffic reductions caused by the 2008-2009 recession.
[87] Brian A. Weatherford et al., *The State of U.S. Railroads – A Review of Capacity and Performance Data* 4 (2008) [herinafter *RAND Study*].
[88] *Id.*
[89] *Id.* at 37.
[90] FRA, *supra* note 85, at 15.
[91] *Rand Study*, *supra* note 87, at 23.
[92] *Id.* at xi.
[93] *Id.* at 38.

is effectively unable to access the other rail carrier because of the extremely high barriers erected as a result of the agency's precedent. However, under a broader reciprocal switching regime, the shipper would be able to access a choice of carriers. If the incumbent's route were the more efficient of the two overall, competition would presumably permit the incumbent to retain the traffic, to the benefit of overall system efficiency and productivity. But in a broader reciprocal switching regime, if the competitive rail carrier's route were the more efficient, competition (assuming a competitive reciprocal switching charge) would permit the shipper to access the more efficient route. Under such a regime, system capacity would be maximized.

b. <u>The Christensen Report confirms that a broadening of reciprocal switching would not harm the railroads' financial health</u>

In its Notice in this proceeding, the Board took note that it had recently commissioned Christensen Associates, Inc. to perform an independent study to examine competitive access issues ("Christensen Competition Report").[94] The Christensen Competition Report noted that, for open-access policies to produce an overall gain in economic welfare, "the effects of lower prices to shippers, increased output, and/or increased service quality due to competitive pressures must outweigh any increase in railroad costs. Furthermore, . . . the economic assessment of the likely effects of these proposals must include the impacts on railroad profitability and investment incentives."[95] The Christensen Competition Report went on to present a summary of the likely economic effects of various competitive access proposals, including reciprocal switching.[96] The Christensen Competition Report noted:

> Of the various open-access policies proposed in recent legislation, those policies that propose incremental changes – *e.g., reciprocal*

[94] See, Lauritis R. Christensen Associates, Inc., *A Study of Competition in the U.S. Freight Railroad Industry and Analysis of Proposals That Might Enhance Competition* (2009), http://www.lrca.com/projects/railroadstudy/ [hereinafter *Christensen Competition Report*].
[95] 3 *Id.* at 22-12.
[96] *Id.* at 22-13.

> *switching and terminal agreements – will be the least costly in terms of loss of economic efficiency and, in our opinion, the most likely to produce competitive responses by railroads.* The losses of economies of density and vertical integration, and the likely negative impact on incumbent investment incentives, are among the economic efficiency costs that must be weighed against any potential gains. Of course, to the extent that competitive responses result and traffic increases, static efficiency losses may be overcome – e.g., there would be a likely gain in economies of density if volumes increase.
>
> . . . .
>
> *[I]ncremental policies such as reciprocal switching . . . are most likely to produce an outcome of increased railroad competition as length-of-haul economies are least affected by end-point open access.*[97]

Table 22-1 summarized the Christensen Competition Report's conclusions by indicating that, reciprocal switching would likely result in "potential gains" with respect to economies of density; would produce only "small losses" or "small effects" with respect to length of haul economies, investment incentives, railroad profitability, and coordination costs; would "most likely" result in competitive responses by carriers; and would "most likely" produce shipper gains. The Report's overall conclusions on reciprocal switching were significant: "[w]e believe that incremental policies such as reciprocal switching and terminal agreements *have a lower potential of leading to adverse changes to industry structure, costs, and operations, and additionally have greater likelihoods of resolving shipper concerns via competitive market responses.*"[98]

7. <u>Under general court precedent, the Board has the broad discretion and wide legal authority to revise its rules on reciprocal switching</u>

As the Board well knows, the law does not require regulations and precedent to remain set in concrete forever. Administrative agencies are permitted to change their policies and reverse prior conclusions as long as the statute permits such discretion and as long as the

[97] *Id.* (emphasis added).
[98] *Id.* at 22-14 (emphasis added).

agencies explain themselves adequately.[99] Indeed, an agency's view of what is in the public interest may change, with or without a change in circumstances.[100] But the agency must supply a reasoned analysis to support its change. *Id.*

As noted by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 863 (1984), an agency interpretation "is not instantly carved in stone." The Board may change its policies, to the extent that the Interstate Commerce Act permits, so long as it acknowledges its prior policy and provides a reasoned basis for the changed policy.[101] Thus, if the STB concludes that circumstances now require a different accommodation of the conflicting goals of the National Transportation Policy, that new interpretation will also enjoy the deference of the courts under the *Chevron* doctrine, as long as the new interpretation is also a reasonable reading of the statute and the agency adequately explains the reason for its change.

The fact that the Congress passed ICCTA in 1995 does not change this conclusion. ICCTA was intended not to make substantive changes to the Interstate Commerce Act (with a few explicit exceptions). The Board should not be dissuaded from amending its policies because of changed circumstances or because it believes that a different policy response is required. Indeed, the Board has changed pre-ICCTA policies after ICCTA, despite the passage of the Act. For example, when the Board concluded in 1999 that it should alter its "market dominance" rules to exclude "product and geographic competition" in most circumstances, it did so despite the fact that its prior decision including product and geographic competition long pre-dated ICCTA, and

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[99] *Motor Vehicle Mfr's Ass'n v. State Farm*, 463 U.S. 29, 42, 57 (1983).
[100] *Id.* at 58; *see also*, *BNSF Railway v. STB*, 526 F.3d 770, 779-80 (D.C. Cir. 2008) (holding that the STB may change how it implements it statutory duties with or without a change in circumstances).
[101] See, *e.g.*, *FCC v. Fox*, 129 S. Ct. 1800, 1811 (2009) (holding that to change its position, an agency must show that: (1) the new policy is permissible under the statute; (2) good reasons exist for the policy; and (3) the agency believes the new policy is better); *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971) ("An agency changing its course must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored.").

its new policy post-dated ICCTA.[102] This decision was affirmed by the D.C. Circuit, which analyzed the decision under the familiar deferential standard of *Chevron.*[103] The same principle applies here: regardless of the passage of ICCTA, the Board has wide discretion to interpret the standards under which it will establish reciprocal switching under 49 U.S.C. § 11102(c).

8. <u>It would be unlawful and contrary to Congressional intent to constrain the "practicable and in the public interest" standard by the "necessary to provide competitive rail service" standard</u>

In its Notice directed to 49 U.S.C. § 11102(c), the Board asked the parties in particular to address "whether the broad 'practicable and in the public interest' standard in the statute should be constrained by the provision permitting relief "where . . . necessary to provide competitive rail service." The Interested Parties believe that the statute is clear, that these are alternative and independent tests, and that it would be unlawful to constrain the former by the latter.

At the outset, it should be noted that it is not at all clear that the "necessary" test is narrower than the "practicable/public interest" test. Indeed, it could be argued that the latter is broader (i.e., more permissive) than the former. But without getting into a metaphysical discussion as to which test is "broader," it is very clear from both the wording of the statute and the Board's own precedent that these are *alternative* and *independent* tests. The statutory wording is clearly in the alternative: "[t]he Board may require rail carriers to enter into reciprocal switching agreements, where it finds such agreements to be practicable and in the public interest, *or* where such agreements are necessary to provide competitive rail service."[104] If Congress had

[102] *See Mkt. Dominance Determinations – Prod. & Geographic Competition*, 3 S.T.B. 937 (1998).
[103] *Ass'n of Am. R.Rs. v. STB*, 306 F.3d 1108 (D.C. Cir. 2002).
[104] 49 U.S.C. § 11102(c) (emphasis added).

intended the former to be constrained by the latter, it would have chosen statutory language to indicate such an intent.[105]

Moreover, the legislative history also makes clear that these are alternative and independent tests. As noted in Section IV.A.1 and 2, above, the Staggers Act Senate Report noted that the "practicable and in the public interest" standard was the "same standard the Commission [had] applied for many years in considering whether to order the joint use of terminal facilities" under current 49 U.S.C. § 11102(a) (then 49 U.S.C. § 11103(a)). The addition of the "necessary" standard was new, and was clearly intended to provide an alternative to the traditional "practicable/public interest" test that had previously been applied by the agency in the terminal trackage rights context. For the Board to condition the one by the other would therefore violate both the statutory wording and the Congressional intent.

B. THE BOARD HAS WIDE DISCRETION TO ESTABLISH TERMINAL TRACKAGE RIGHTS UNDER SECTION 11102(a)

For many of the same reasons discussed at length in the previous section — the use of the word "may," the need for the Board to issue findings determined solely by it; the use of the broad "practical/public interest" standard, and the general broad standard used by the courts in reviewing agency actions — the Board has wide discretion to establish terminal trackage rights under 49 U.S.C. § 11102(a). Admittedly, the statutory provision granting the Board the authority to order terminal trackage rights is more demanding than the statutory provision authorizing the Board to order reciprocal switching. Under the terminal trackage rights provision of § 11102(a), the agency is required to find not only that the trackage rights are "practicable and in the public

[105] For example, the statute could have used the word "and" in place of the "or"; or could have been worded to permit the Board to require rail carriers to enter into reciprocal switching agreements where it finds such agreements to be practicable and in the public interest, but *provided that* the Board finds that such agreements were necessary to provide competitive rail service. But wording such as "provided," "unless," "on the condition that," etc., were *not* chosen, indicating clearly that Congress intended the tests to be alternative and independent.

interest," but that the trackage rights would not "substantially impair[] the ability of the rail carrier owning the facilities or entitled to use the facilities to handle its own business." This reflects the more invasive nature of trackage rights compared to reciprocal switching.

Nevertheless, a review of precedent under the joint use of terminal provisions confirms that the agency's standard had for many years been a broad one, giving the agency wide discretion. For example, in *Jamestown*, the agency exercised its authority to order joint use of terminal facilities when it found that such use would be in the public interest, would be practicable, and would not substantially impair the carrier owning or entitled to enjoyment of the facilities to handle its own business.[106] In cases before the Staggers Act, the Commission identified the components of the public interest standard for ordering the joint use of terminal facilities. When making a public interest determination, the agency considered the interest of the shippers involved, carriers, and the general public.[107] Two prerequisites existed to finding public interest. First, there needed to be an actual necessity or compelling reason for the joint terminal use.[108] Mere desirability or convenience was insufficient.[109] Second, existing service needed to be inadequate.[110] In addition, the Commission identified a number of factors that would inform a public interest determination, such as: (1) the financial consequence to the carriers involved;[111] (2) the disparity between the traffic gained by the carrier gaining the use and the traffic lost by the carrier providing the use; and (3) the inconveniences that may result to the shipping and traveling public in general.[112] However, these factors were themselves extremely general, and

[106] *Jamestown, N.Y. C. of C. v. Jamestown, W & N. R. R. Co.*, 195 I.C.C. 289, 292 (1933).
[107] *Id.*
[108] *Id.*
[109] *Mfrs. Assoc. of York, PA. v. Pa. R.R.*, 73 I.C.C. 40, 50. (1922).
[110] *Id.* at 49.
[111] *Hastings Commercial Club v. Chicago, Milwaukee & St. Paul Rwy.*, 107 I.C.C. 208, 216 (1926)
[112] *Id.*

gave the agency wide discretion in interpreting them. It is clear, then, the agency exercised considerable discretion in making a public interest determination under 49 U.S.C. § 11102(a).

C. THE BOARD HAS BROAD DISCRETION TO CHANGE ITS POLICIES WITH RESPECT TO BOTTLENECK RATES

For the same reasons that adopting revised policies on reciprocal switching and use of terminal facilities is well within the Board's statutory authority, the Board also has broad discretion to revise its outdated bottleneck rate policy. Indeed, ICCTA entitles a shipper to a common carrier rate upon reasonable request. But, in the so-called "Bottleneck Decisions," the Board permitted a railroad to refuse to quote a bottleneck segment rate, even if a bottleneck rate would facilitate rail-to-rail competition for most of the distance between the origin and destination.[113]

The Board's "Bottleneck Decisions" facilitate conscious parallelism and should be reversed by the Board to allow for additional rail–to-rail competition. A shipper seeking a bottleneck rate from an origin to a destination served by the same carrier will almost always be rebuffed or have the quoted rate limited to a local movement with no combination rate beyond allowed. The purpose of such a refusal is obvious; the carrier forecloses the possible competition offered by a connecting carrier at the interchange point. Today, where there are so few competitive choices, the ability of a railroad to refuse to quote a bottleneck rate to an interchange point makes rail-to-rail competition virtually impossible. The current bottleneck doctrine is an anachronism that would not be tolerated in any other industry. (See Section VII, below, for a discussion of how reasonable access is maintained in telecommunications deregulation.)

It is clearly reasonable, in general, for a shipper to request a common carrier bottleneck rate to a point of interchange that would lead to a routing that, because of the non-bottleneck

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[113] *Cent. Power & Light Co. v. S. Pac. R.R.*, 1 S.T.B. 1059 (1996), *clarified by Cent. Power & Light Co. v. S. Pac. R.R.*, 2 S.T.B. 235 (1997), *aff'd in part, MidAmerican Energy Co. v. STB*, 169 F.3d 1099 (8th Cir. 1999).

carrier, is more efficient or otherwise more commercially advantageous to the shipper.[114] It defies common sense, and the pro-competitive purposes of the Staggers Act, to say that a carrier's common carrier obligation does not apply when it would require the carrier to compete with another carrier.[115]

The Supreme Court's decision in *Great Northern Railway v. Sullivan*, 294 U.S. 458 (1935), is not an obstacle to overturning the Board's "Bottleneck Decisions" for three reasons. First, *Great Northern* did not involve a request for a "bottleneck rate," but rather an effort at challenging the "divisions" between two railroads participating in the same joint rate. Second, the Staggers Act was enacted long after *Great Northern* was decided, and adopted a "pro-competitive" rail transportation policy. The "bottleneck" rule prevents, rather than promotes, rail-to-rail competition, and so is inconsistent with the Staggers Act. Third, the Eighth Circuit's decision affirming the Board's "Bottleneck Decisions" held that the existing statute was ambiguous, and deferred to the STB's reasonable interpretation of the statute. The Court's language implied that it would have affirmed a contrary reading, *i.e.*, that the existing statute requires railroads to quote "bottleneck rates."[116]

The lack of a "bottleneck" rate deprives shippers of the ability to benefit from competition where it already exists, and it also deprives them in many cases of the most efficient routes. Instead, shippers are forced to rely heavily upon regulation to ensure reasonable rates for the entire movement from origin to destination, including the competitive segments, or to forego any regulatory constraint at all due to the cost and complexity of bringing such extensive rate

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[114] Exceptional situations, in which there is a dispute whether the shipper's chosen point of interchange is feasible or otherwise reasonable, can be dealt with on a case-by-case basis.

[115] 49 U.S.C. § 10705(a)(2), the "long-haul, short-haul" provision, which the Board cited in its "bottleneck rate" decision, is not to the contrary. It clearly provides the Board with discretion to require railroads to participate in through rates (or, as the railroads are fond of putting, to "short-haul themselves."). *See supra* note 45.

[116] *MidAmerican Energy Co. v. STB*, 169 F.3d 1099, 1107 (8^{th} Cir.) ("Regardless of how we would resolve the tension in the Act if we were to independently rule on the utilities' claims, we cannot say that the Board's interpretation was incorrect."), *cert. denied*, 528 U.S. 950 (1999).

cases. Shippers should be entitled to competition, because that was the promise of the Staggers Act. And shippers should certainly be entitled to efficient transportation; that has been the law since 1887.[117]

It follows that the Board should overturn its "bottleneck" rate rule, and may do so as a reasonable interpretation of the existing statute, based on the Eighth Circuit's determination that the statute is ambiguous and because the Board is entitled to deference in construing such provisions.[118]

V. CHANGES TO THE BOARD'S COMPETITION RULES AND PRECEDENT WOULD ASSIST THE U.S. ECONOMY

The Board should consider of the utmost importance the question whether railroad rates and other charges have been increased to such an extent that they are now clearly harming the U.S. economy, in any number of ways. Set out below are examples of the widespread harm to the U.S. economy that high rail rates and poor railroad service cause.

Competition with Foreign Interests. U.S. railroads do not compete with railroads in China, India, Europe, or any other part of the world economy — but most of their customers, especially grain, chemical, clay, and other manufacturing interests, compete with grain, chemical, clay and manufacturing interests in those countries. Therefore, almost every time a rail customer is charged an excessive rate, it hurts American industry's ability to compete with China and other foreign countries and the industries in those countries. Even where rail customers, such as electricity generators, do not compete with foreign entities,[119] American

[117] *E.g., Consolidated Rail Corp. v. United States*, 646 F.2d 642 (D.C. Cir.), *cert. denied*, 454 U.S. 1047 (1981); *Akron, Canton & Youngstown R.R. v. ICC*, 611 F.2d 1162 (6th Cir. 1979), *cert. denied*, 449 U.S. 830 (1980).
[118] *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984).
[119] There is a limited amount of electricity that moves across the U.S.-Canadian border, depending on availability and price. Similarly, there is a limited amount of competition between U.S. and Canadian railroads. Neither circumstance is significant enough to affect the overall picture in most markets, given that rail lines and electricity transmission lines are typically not located in ways that promote competition between the United States and Canada.

consumers are still burdened because rail rates are directly reflected in the cost of the rail customers' goods. Thus, every dollar by which U.S. industry can reduce its shipping costs is a dollar that goes toward creating American jobs and making American goods more affordable.

Below is a sampling of the recent problems that a lack of rail-to-rail competition has been causing American industry.

Coal. The Board is aware of the large increases in coal rates in recent years, as indicated by the many coal rate proceedings on its docket. Basin Electric's rate increased over 100 percent,[120] Dairyland Power's transportation charges increased by 93 percent,[121] and many other coal shippers' rates have increased by comparable amounts in recent years. The level of increases has been so excessive that some rates have been reduced by as much as 60 percent by the STB's rate prescriptions. For example, the STB reduced Basin Electric's rate from approximately 600 percent of variable costs to approximately 240 percent of variable costs. Despite the fact that the rates charged to Basin Electric were some of the lowest in absolute dollars charged to an electricity generator, due to the proximity of the power plant to the Powder River Basin, the Board's rate prescription for Basin Electric reduced its rail transportation costs by approximately $345 million over a 10-year period.[122] The amount of the reparations and the percentage reduction in the rate show how much market power railroads have and how much their rate increases in recent years have had an adverse impact on the price of electricity.

Kansas City Southern is attempting to compete in Mexico for container business that is now carried by BNSF and UP, but KCS's share of the container market is small.

[120] Brief of W. Fuels Ass'n, Inc. and Basin Elec. Power Coop., Inc. at 2, *W. Fuels Ass'n, Inc. v. BNSF Ry.*, STB Docket No. 42088 (Dec. 6, 2005).

[121] *An Examination of S. 772, the Railroad Antitrust Enforcement Act: Before the S. Subcomm. on Antirust, Competition Policy and Consumer Rights of the S. Comm. on the Judiciary*, 110th Cong. 2 (2007) (statement of Sen. Herb Kohl (D-WI), Chairman, S. Subcomm. on Antitrust, Competition Policy and Consumer Rights); *see also*, Marv Balousek, *Rail Rates Rock State Companies*, (Jan. 4, 2007), http://www.railcure.org/media/Rail_Rates_Rock_State_Companies.asp.

[122] *W. Fuels Ass'n, Inc. v. BNSF Ry. Co.*, STB Docket No. 42088, 2009 WL 415499 (Feb. 17, 2009), *aff'd in part sub nom. BNSF Ry. v. STB*, 604 F.3d 602, 604 (D.C. Cir. 2010).

Electricity is perhaps the most important element of industrial costs and consumer costs, with a substantial multiplier effect across the entire economy.

In May 2010, NRG Power Marketing LLC filed a rate-reasonableness complaint against CSX Transportation, Inc., alleging that the rate increases CSX had imposed after their transportation contract had expired were so high that NRG could not operate the electricity generating stations in question, which were located in western New York State. NRG filed a Petition for Injunctive Relief on May 25, 2010, alleging the following, based on affidavits:

> Other than one unplanned train, no coal has moved under this tariff because the Stations have become uncompetitive in the New York State electric market. More importantly, as described in the verified statements attached to this Petition, under the CSXT tariff, little or no coal is likely to move for the duration of this proceeding, leading to a major sustained reduction in output at the Stations and massive irreparable injury to NRG in lost sales as well as additional harm to the public.[123]

NRG went on to show, again based on an affidavit, that the stations in question could not operate unless CSX's rate increases were enjoined, and that the availability of the stations would improve the reliability of the New York State electricity grid during peak summer or winter periods: "The New York electricity market would have more available power generation for hot summer days and cold winter nights."[124] In June 2010, the parties settled, presumably with an agreement for CSX to reduce its rates so that NRG can operate those electricity generating stations again.

Other coal shippers have also brought their complaints to the Board in recent years, including Kansas City Power & Light Company and Oklahoma Gas & Electric Company, both

[123] Petition of NRG Power Mktg. LLC at 2, *NRG Power Mktg. LLC v. CSX Transp. Inc.*, STB Docket No. NOR 42122 (May 25, 2010).
[124] *Id.* at 23.

of which demonstrated that their rates on UP exceeded a reasonable maximum, causing the Board to order substantially lower maximum reasonable rates and reparations.[125]

Arizona Electric Power Cooperative and South Mississippi Electric Power Association are now challenging what they regard as excessive rail rates in pending matters before the Board. Because those are pending matters, we will refrain from commenting on them.

Chemicals. Chemical shippers have filed a number of rail rate challenges in recent years. Of greatest relevance to the Board's question about impacts on the U.S. economy, E.I. DuPont de Nemours and Company ("DuPont") filed several rate complaints in the last few years. In December 2008, DuPont sought a preliminary injunction against CSX to prevent substantial rate increases from taking effect. Accompanying DuPont's motion were several affidavits, including one from a DuPont customer, Occidental Chemical Corporation ("OxyChem"). OxyChem's affidavit demonstrated that the rail rate increases DuPont complained of would, if put into effect and passed through in DuPont's prices to OxyChem, cause OxyChem to lose chemical business at its sole production facility for resorcinol, a chemical adherent used for automobile tires, to a competitor in China.[126] CSX settled with DuPont before the STB ruled on the motion.

The evidence before the Board in various DuPont rate complaint proceedings shows rates with R/VC ratios as high as 500-750% or more. Other shippers, such as Total Petrochemicals USA, Inc., demonstrated that the R/VC ratios for its rates are as high as 1000% or more, for plastics, which are not even a hazardous material. Similar showings have been made by other

[125] *Okla. Gas & Elec. Co. v. Union Pac. R.R.*, STB Docket No. 42111 (served July 24, 2009); *Kan. City Power & Light Co. v. Union Pac. R.R.*, STB Docket No. 42095 (served May 19, 2008).

[126] Affidavit of Robin A. Burns, Vice President-Supply Chain, OxyChem, *E.I. DuPont de Nemours & Co. v. CSX Transp., Inc.*, STB Docket No. NOR 42112 (Dec. 2, 2008) ("INDSPEC ships approximately **[protected material redacted]** tons of product by rail mainly to the automotive markets. This business is currently under tremendous pressure from increasing raw material prices, increasing competition from China, as well as falling domestic demand for original equipment tires due to current economic conditions that are dramatically reducing automotive sales. **[Protected material redacted.]** The additional rail costs INDSPEC would incur while DuPont presents their large rate case will cause irreparable damage to its business going forward.").

chemical shipper complainants. Consistent with the December 2008 Affidavit of Ms. Burns, Vice President-Supply Chain of OxyChem,[127] chemical shippers have reported to CURE that it is often cheaper to produce their products in Asia or the Middle East, and then ship them by ocean carrier to the United States for delivery to the customer, rather than to produce the chemicals in the U.S. and ship them by rail to the same customer. These circumstances suggest not only that the railroads' noncompetitive rates destroy American jobs and business, but also, ironically, that the railroads could make *higher* returns, not *lower* returns, if they reduced their rates (as CSX apparently did in its settlement with DuPont, else DuPont presumably would not have withdrawn its motion for a preliminary injunction and eventually settled that dispute with CSX).

Potatoes. Recently, in Comments filed January 24, 2011 in Ex Parte No. 704, the Washington State Potato Commission submitted substantial comments demonstrating that the exemption for potatoes should be revoked because of the high rail rates and poor service its producer members get from the railroads (primarily BNSF, which controls many of the rail lines in Washington). In fact, despite the fact that railroads have a cost advantage over trucks, and despite the clear preference of the potato producers for rail transportation, the producers showed that only 7% of their produce moves by rail, with the rest moving by truck. This contradicts the railroads' oft-repeated "public service" claims that they are taking goods off the highway and moving them by rail. It is clearly harmful to America's economy to use more fuel to move goods by truck than by rail, given rail's inherent fuel-economy advantage over trucks.

Cement. Portland Cement Association ("PCA") represents 25 cement companies, operating 97 manufacturing plants in 36 states with distribution centers in all 50 states. PCA members account for 97.1 percent of domestic cement production capacity. PCA explained its members' rail transportation problems this way:

[127] *Id.*

More than 80 percent of U.S. cement manufacturing plants are captive to a single railroad. Due to the absence of competition, these plants are charged substantially higher rates and often receive less reliable service. . . .

. . . .

Many shippers of cement and related products are reporting double-digit increases in rail rates, far beyond the effects of inflation. . . .

The STB's statistics show that nearly 40 percent% of cement-industry-related commodities transported by rail in 2005 have a revenue-to-variable-cost ratio of more than 180 percent, up from less than 30 percent% just four years earlier. A review of 2009 statistics doesn't show any appreciable changes from the 2005 figures. This means that, as a result of the exemption, nearly two-fifths of cement shipments (producing revenues to the rail industry of over $615 million/year) are exempted from the protections provided by the statue.[128]

A major cement producer, CEMEX, has worldwide headquarters in Monterrey, Mexico, with U.S. headquarters in Houston, Texas. In comments filed in Ex Parte No. 704, on Feb. 1, 2011, Cemex noted that the requirements of the cement industry are to provide products of consistently high quality and reliable service to customers and communities. In the U.S., the majority of CEMEX's products that are not shipped directly from the production sites are shipped by rail to distribution centers and subsequently delivered by truck to customers. The majority of CEMEX's rail routes are "captive" (i.e., there is no choice of rail carrier). Accordingly, CEMEX is increasingly dependent on rail transportation and was seeking the removal of commodity exemptions so that fair and reasonable freight rates and service could be maintained since changes in the rail and cement industries have significantly reduced competitive transportation alternatives.

Another cement producer, Holcim US, is a leader in the domestic cement industry, serving 44 states through a network of 15 production facilities and 63 distribution terminals. Of

[128] Comments of Portland Cement Ass'n at 2, 9-10, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011) (footnote omitted).

the 6.5 million tons of cement that Holcim distributes, 40% is shipped via rail. In comments filed January 31, 2011 in Ex Parte No. 704, Holcim explained its rail problems this way:

> Only 3 of the 11 Holcim US production facilities are serviced by more than one Class I railroad. However, the potential for competition at these 3 facilities is negated by the fact that all of our receiving terminals are single served. Absent the need to be competitive with each other, the railroads hold enormous pricing power over Holcim due to multiple factors: long distances between origin and destination, we ship bulk materials, large volumes of bulk materials, terminal infrastructure, location and geography. The railroads are the only viable option for Holcim to maintain a meaningful presence in many North American markets.....With no competitive options, no federal protection, and a passive government agency that is failing to provide effective oversight, shippers of exempt commodities [such as Holcim] face unrestrained shipping costs and unreliable service, and are ultimately put at a competitive disadvantage.[129]

Crushed Stone. Texas Crushed Stone operates a limestone quarry halfway between Round Rock and Georgetown, TX. Historically, about half of what comes out of the quarry is shipped via rail. In comments filed January 31, 2011 in Ex Parte No. 704, Texas Crushed Stone explained its rail problems this way:

> Today, the railroads have incredible pricing power and they have made decisions that have made a significant negative impact on Texas Crushed Stone's ability to be market competitive.... We have experienced a series of aggressive rate increases and more than one railroad representative told us they did not want our business. While Georgetown Railroad connects with two Class I railroads, the preponderance of the shipments are captive as most of the customers are local to one railroad. Trucks are not a solution.... Bottom line result is that we have lost business.[130]

[129] Comments of Holcim US at 3, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Feb. 22, 2011).

[130] Comments of Texas Crushed Stone at 4-5, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011).

Texas Crushed Stone included a graph with its comments that depicts its annual carloads since 1980. The graph shows that it shipped slightly less than 55,000 rail carloads per year in 1980, but ships only about 10,000 rail carloads in 2010.[131]

> We met with the offending railroad and presented our case, focusing on the fact we are not competitive and the resulting loss of business, but they maintained their position.
>
> We considered the option of coming to the STB with a complaint, but we would have been required to request revocation of the exemption and were reluctant to assume additional legal costs, especially when the outcome would have been uncertain.[132]

<u>Steel.</u> AK Steel Corporation is a major steel producer with approximately 6,500 employees engaged in the production of flat-rolled carbon, stainless and electrical steels, and tubular products at seven major steelmaking and finishing plants in Indiana, Kentucky, Ohio, and Pennsylvania. AK Steel, which ships approximately 15 million tons of steel products annually, relies on the railroads to transport the majority of its freight due to the size, weight and other characteristic. That freight is not amenable to shipment by motor carriage or other transportation modes besides rail. In its comments filed January 31, 2011 in Ex Parte No. 704, AK Steel explained:

> AK Steel in many instances in captive to a single railroad for its transportation requirements, and it is subject to monopoly railroad power and market dominance railroad pricing, even with the exempt commodities it ships.
>
> [F]or shippers such as AK Steel that move substantial amounts of exempt commodities, and that have littler or no competitive options for that service, the railroad exemptions have created significant competitive difficulties. As for these movements, the railroads effectively operate as a deregulated monopoly.
>
> The bottom line impact of [STB's] decisions for an exempt commodity shipper is that in order to obtain a common carrier rate or challenge a common carrier rate, it is faced with the prospect of

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[131] *Id.* at 5.
[132] *Id.* at 6.

> having to bring a revocation action against the Board. And even if the shipper can obtain a common carrier rate voluntarily from a carrier, at least if a complaint is filed under the Board's *Simplified Standards*, the Board's policy is to generally stay the proceeding automatically pending the outcome of the request for revocation. This means, at minimum, substantial and unnecessary administrative delay for a shipper seeking to obtain regulatory relief.... The delay, uncertainty, and expense of brining a separate revocation action, in combination with a rate case, creates serious barriers to access of the Board's regulatory relief provisions for shippers such as AK Steel, and they frankly discourage shippers of exempt commodities from even trying to seek relief.[133]

Forest Products. The American Forest & Paper Association ("AF&PA") is a national trade association of the forest products industry, representing pulp, paper, packaging, and wood products to manufacturers, and forest landowners. The forest products industry relies on the railroads for the transportation of raw materials to its mills and for bringing finished products to the marketplace. Most of this traffic is currently exempt from STB regulations. In its comments filed January 31, 2011 in Ex Parte No. 704, AF&PA explained its members' rail-transportation problems this way:

> The reduced rail competition and captive status of many paper and forest product companies has enabled the railroads to impose substantial double digit rate increases upon some companies during the past decade, and "take it or leave it" contract terms, both evidencing the exercise of substantial market power. At a minimum, the substantial reduction in rail competition has increased the likelihood of market abuses which should be evaluated by the Board.[134]

Although truck transportation is an option for shipping these exempt products, rail transportation is more efficient and cost-effective particularly for long-haul movements. Many paper mills were built to receive inbound logs and ship outbound products via rail and, thus,

[133] Comments of AK Steel, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011).
[134] Comments of Am. Forest & Paper Ass'n at 12-13, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011).

were not designed to handle substantial volumes of trucks. Weight and size limitations of trucks are also a restricting factor for these commodities and, in some regional markets, there are truck capacity shortages. Other factors adversely affecting motor carrier costs and competitiveness include a long-term driver shortage and increased costs due to higher fuel prices, as well as new regulatory changes involving driver hours of service and DOT's new CSA 2010 safety program.

International Paper Company ("IP") is the largest manufacturer of paper and paper products in the United States and operates from a number of mills and other facilities in various locations around the country. On March 11, 2011, IP filed a Petition to Stay an exemption in Finance Docket No. 35465. In that Petition, IP stated that it owns and operates a large mill at Prattville, Alabama, which is located on the line of track that is presently owned and operated by NS between Maplesville and Montgomery, Alabama.[135] IP is heavily dependent on rail transportation to move its outbound goods to various destinations around the country. For example, in 2010, NS transported over 5,000 outbound boxcar shipments for IP, and IP anticipates that its outbound rail shipments will substantially exceed that number in 2011. IP noted the following about transportation on the Maplesville-Montgomery line:

> [T]he issue of service on this line has in recent years become significantly problematic due to NS service deficiencies. In 2009, NS provided this mill with 6 to 7 switches per week and generally filled 100% of IP's boxcar needs. The situation has significantly deteriorated since then. In February 2010, NS' service and ability to supply boxcars began to decline precipitously, so that IP has held numerous meetings through the end of the year with a NS Senior Management to discuss the service failures and attempt to get those issues resolved. NS blamed the service failures on crew shortages and advised IP that normal service levels would return by the end of the year. That was not the case. In early December 2010, the 43 miles of track that is the subject of the Notice of Exemption was inspected by the Federal Railroad Administration and found to be in such poor condition that speeds were reduced to 10 miles an hour. This reduction in speed further adversely

[135] Petition of Int'l Paper Co. at 2, *Autauga N. R.R.*, STB Docket No. FD 35465 (Mar. 11, 2011).

affected the crew hours, which, in turn had the affect of reducing switching IP to only 3 times per week. Consequently, although IP has been complaining about the poor track conditions with its reduced speeds, and while NS is well aware that the track needed maintenance, NS has never provided any plan or timeline to repair the track. The result? While NS essentially fulfilled 100% of IP's boxcar orders in 2009, that number dropped to 79.7% in 2010. This situation has further deteriorated in 2011. In January, NS' car supply order fulfillment was down to 53%, and this declined even further to only 48% in February. And, notwithstanding IP's needs, NS is still only switching the mill 3 times a week, and the 43 miles of line are still under an FRA-ordered speed reduction. This is an intolerable situation.[136]

Popcorn. Weaver Popcorn Co. is an 83-year old, fourth-generation, family-owned company headquartered in Noblesville, Indiana with two plants located elsewhere in Indiana. It has been exporting to countries around the world for over 50 years and exports remain central to its business. Growth in the world market substantially exceeds the growth level found in the U.S. market. In its comments filed February 1, 2011 in Ex Parte No. 704, Weaver explained its rail-transportation problems this way:

> The primary competition American producers' face in overseas export growth is not from each other but from the newly established Argentina producers of popcorn. American YTD 2010 exports of popcorn were approximately 190mm pounds and Argentina exports of popcorn were approximately 550mm pounds. America is losing this export fight. We face two key issues in our competition with Argentina producers: various cost issues associated with the tax-favored treatment of the Argentina popcorn industry and the freight disadvantage faced by American producers.
>
> Our net weight allowed on a export container is currently restricted by the fact American exporters have been obliged to ship the first leg of all our shipments by dray over the road "OTR" to a container ramp. We have used in the past Detroit, Chicago, and Indianapolis. Today the overwhelming majority of our containers from both plants pass through Chicago ramps. This OTR dray/truck passage for the first 180 miles to Chicago of our products' passage dictates the net weight we can ship for the entire

[136] *Id.* at 3-4.

5,000, 6,000, or 8,000-mile journey! The result of this is significant. Weaver, like other American producers, can ship at most 21 tons on a 20' export container of bulk popcorn. Our Argentine friends, without the same weight restrictions on their own road system, can ship 25-26 tons. This results in, usually, a 20-25 percentage freight subsidy for our Argentina competitors. This freight differential is substantial in a bulk commodity market.[137]

Weaver went on to explain the response it received from Norfolk Southern to its competitiveness problem:

> Unfortunately our proposals have been ignored for some time by our primary Class I partner, the Norfolk Southern Railroad. They have refused to provide an answer in response to our repeated requests to invest over $1mm into shifting our exports onto the safer, more weight capable, American railroad system. We understand, indirectly, that Norfolk Southern may have a desire to concentrate their container operations into certain ramps that offer economies of scale.
>
> We ask the Surface Transportation Board to review this situation to see if it can see the merit in allowing private companies like Weaver to invest their own monies into shifting their exports off the interstate road system and onto the rails, thereby reducing their freight costs and increasing American export volumes.[138]

<u>Metal Castings</u>. In its Ex Parte No. 704 comments filed on February 1, 2011, the Northwest Ohio Regional Economic Development Association explained that one of its members has a hurdle to overcome to compete in the international market because of the actions of the railroads:

> A large casting facility in northwest Ohio is currently shipping industrial castings for foreign assembly. These castings are currently loaded into shipping containers (COFC) at the casting facility and are hauled by truck to the rail ramp in Chicago where they are loaded onto flat cars for rail transport to destination. The shipper has conducted an internal cost analysis study that suggests that $2.5 to $3.0 million per year could be saved by eliminating the

[137] Comments of Weaver Popcorn Co. at 1-2, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Feb. 1, 2011).
[138] *Id.* at 2.

> truck move to Chicago by loading the castings directly onto rail cars at the casting facility. Unfortunately, the Class I railroad serving this plant is reluctant to provide direct TOFC or COFC service at the shipping point. In contrast, a short line rail company nearby is more than willing to accommodate this type of service if it can be assured that competitive service is available for the long haul portion of the move via its connecting Class I railroad.[139]

Automobiles. The Alliance of Auto Manufacturers represents the interests of a group of automobile manufacturers. Approximately 77 percent of all car and light truck sales in the United States are attributed to its 12 members. In its comments in Ex Parte No. 704 filed January 31, 2011, the Alliance explained its members' rail problems this way:

> Because most geographic regions are served by no more than two railroads and often only one provides service to a[n] auto producer's facility, railroads have little incentive to compete. Bottleneck segments also have lengthened as a result of mergers, which have increased the distances for which a location is captive to a single railroad. Thus, an auto manufacturer's ability to substitute a movement on one rail line for a movement on another rail line is limited. Further, they cannot simply shift production to difference geographic regions to take advantage of competition, because many production facilities have shut down in recent years, and the cost and downtime required to retool their plants in order to shift production among existing plants is prohibitive.
>
> ....
>
> Auto manufacturers have experienced first hand the negative competitive effects of Class I railroad consolidation.... Rail rates have risen steadily over the last 5-6 years while railroads have reduced their service commitments.[140]

The Alliance also explained the inadequacy of intermodal transportation, especially for shipments of finished vehicles, large and heavy parts and long distance transportation. Although the vast majority of inbound auto parts move by truck today, a sizeable volume still moves by rail because trucks are not a viable option due to the size and weight of finished vehicles and

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[139] Comments of Northwest Ohio Regional Economic Development Association at 1-2, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Feb. 1, 2011).

[140] Comments of the Alliance of Automotive Manufacturers at 1, 5, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011).

parts such as frames, engines and axels. Therefore, auto manufacturers are captive to rail for these inbound parts and accessories.

General Motors LLC ("GM") is, obviously, one of the largest producers of automobiles in the United States. According to GM's comments filed January 31, 2011 in Ex Parte No. 704, it ships 3.1 million finished vehicles per year, 75% of which move by rail. In addition, approximately 25 percent of GM's inbound parts are delivered by rail. In those comments, GM explained its rail-transportation problems this way:

> GM has very few alternatives to rail for transporting this traffic. Consequently, GM believes that this traffic is captive and should be afforded the regulatory protections that presently are denied because of the Automobile Exemptions [adopted by the Interstate Commerce Commission].
>
> GM has observed a reduction in the number of competing Class I rail carriers since 1993 as a result of carrier consolidation. In 1993, twelve Class I carriers existed. Today, only seven Class I carriers exist. Due to this reduction in competing carriers, the eastern and western halves of the nation's rail system are effectively served by only two Class I carriers each. Most GM facilities are captive to a single railroad. Carrier consolidation has increased the length of these bottleneck segments, and therefore, the distances over which GM is captive to a single rail carrier.
>
> GM also has experienced significant changes since 1993. We are a much leaner and more efficient company that producers cars at fewer, larger facilities. We also have implemented "just-in-time" production, which reduces inventory but requires very precise delivery schedules for inbound parts. The combination of fewer GM facilities and fewer railroads means that OM is much more dependent upon a smaller number of rail carriers to fulfill its rail transportation needs. GM's rail transportation needs differ for the outbound shipment of [finished motor vehicles] ("FMVs") and the inbound delivery of parts and accessories. GM depends heavily upon rail for the outbound transportation of approximately 75% of its FMVs. Although GM only relies upon rail for 25% of its total transportation of inbound parts, that figure represents nearly all of GM's shipments of large and/or heavy parts, such as frames, engines, transmissions and axles. Such high percentages move by rail because trucks are not effective competitive alternatives.

For FMVs, motor carriage is a limited transportation alternative to rail. GM's use of trucks to transport FMVs is mostly over short distances directly from a manufacturing facility to a dealer or from a rail distribution center to a dealer. GM's break-even threshold distance for using truck versus rail, based upon cost, has increased from 250 miles to approximately 400 miles m the span of just five years, because rail rates have increased at a much greater pace than truck rates during this tune. At longer distances, trucks are not a practical alternative to rail because they do not offer the capacity or efficiencies of rail.

GM does not have the ability to discipline rail rates by trucking FMVs around rail bottlenecks to the rail head of a competing railroad. Sufficient truck capacity supply does not exist to do this except at the margins. Moreover, the added cost and transit time deters the extensive use of truck-arounds. Further, the extra vehicle handling required by transloading from truck to rail increases the potential for damage to FMVs, which impacts sales and customer perceptions of quality. Because of the difficulty and added costs of transloading around bottleneck segments, GM only does so on isolated lanes where there is a service failure by a railroad or other significant rail quality concern.

GM's "just-in-time" production means that we already receive most inbound parts by truck. Rail supply cannot meet the service and transit time requirements of "just-in-time" production. This is another major change since 1993. Consequently, just about every inbound part that can be delivered efficiently by truck is delivered to a GM plant b^ truck today. The 25% of parts that currently move by rail supply cannot be transported cost-effectively by track because they are heavy and/or large components, such as frames, engines, transmissions, and axles. If trucks were a viable competitive option for these shipments, GM almost certainly would be using trucks today, because it must carry a larger inventory of rail-delivered parts due to less precise rail service windows. Thus, OM is captive to rail for these parts.

Another significant change since 1993 has been passage of the ICC Termination Act in 1995 ("ICCTA"). When the ICC granted the Automobile Exemptions, it noted that the exemptions would relieve administrative and paperwork burdens associated with tariff filing and contract summary filing, insulate the issue traffic from frivolous, but potentially burdensome regulatory proceedings, and allow quick and unhindered rate and service adjustments when changed market conditions require them. Just two years later, ICCTA provided these same benefits to all railroads and shippers without exemptions. For instance, ICCTA repealed the tariff and

> contract filing requirements, and increased the railroads' flexibility to make rate and service adjustments. From a shipper's perspective, there no longer are any benefits to exemptions to offset the loss of regulatory protections.
>
> Many of the circumstances that motivated the ICC to establish the Automobile Exemptions have changed since 1993. Today, GM has fewer rail transportation options and is captive to a single rail carrier at more plants and over greater distances. OM also has optimized its use of transportation modes m such a manner that, where it currently ships by rail, OM cannot make extensive use of other transportation modes. Because OM must use rail in those instances, it is just as captive as most non-exempt rail traffic. Therefore, GM supports an in-depth review of the Automobile Exemptions and whether automobile manufacturers require protection from abuses of market power.[141]

All of the examples above make a point that is crystal clear — rail rates harm U.S. producers of electricity, grain, chemicals, lumber, and other products, and therefore not only deprive U.S. customers of funds that could otherwise be used to produce jobs through demand in this country, but in many cases, effectively cause manufacturers to produce their products abroad, costing the U.S. valuable jobs.

VI. FERC's INTRODUCTION OF COMPETITION INTO THE NATURAL GAS PIPELINE INDUSTRY WAS A SUCCESS, AND DID NOT PREVENT THAT INDUSTRY ATTRACTING CAPITAL.

Experience in other industries demonstrates that the railroad industry can adapt to, and thrive in, a competitive environment. Many industries have been made more competitive in recent years, by a variety of governmental actions. A particularly useful case in point is the natural gas pipeline industry.

The Federal Energy Regulatory Commission ("FERC") regulates the natural gas pipelines under the Natural Gas Act ("NGA").[142] FERC set out to introduce competition into

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[141] Comments of Gen.Motors LLC at 1-3, *Review of Commodity, Boxcar & TOFC/COFC Exemptions*, STB Ex Parte No. 704 (Jan. 31, 2011).
[142] 15 U.S.C. § 717 (2006).

that industry by regulatory action in the 1980s. Prior to that time, natural gas pipelines not only transported gas but also sold it in one "bundle" to customers. Traditionally, after producers extracted the gas, pipelines bought it at the wellhead, transported it, and then resold it to local distribution companies.[143] Under the authority of the NGA, FERC regulated the sales for resale of natural gas as well as the interstate transportation of the gas, leaving the states to regulate local distribution.[144]

Prior to FERC's introduction of competition into the natural gas pipeline industry, the natural gas industry as a whole suffered several supply-and-demand problems. In the 1970s, the lower-than-market wellhead price of gas caused a shortage and few producers wanted to search for new sources because the economic return was too low.[145] In response to that situation, Congress passed the Natural Gas Policy Act of 1978,[146] which then allowed purchasers of natural gas to enter into "take or pay" contracts.[147] Naturally, demand decreased due to the rising prices.

In the late 1980s and early 1990s, without legislation requiring it to do so, FERC issued two orders which restructured the natural gas pipeline industry and brought about the current competitive climate. First, Order No. 436[148] established "open access" requirements on pipelines, requiring owners to agree to non-discrimination requirements in order to receive blanket certificates for third-party transmission.[149] The D.C. Circuit mostly upheld FERC's decision, although the Court vacated and remanded the case to FERC due to its treatment of the

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143 *United Distribution Cos. v. FERC*, 88 F.3d 1105, 1122 (D.C. Cir. 1996) (*citing* Edward C. Gallick, *Competition in the Natural Gas Industry* 9-12 (1993)).
144 *United Distribution*, 88 F.3d at 1122.
145 *Id.* at 1123.
146 15 U.S.C. § 3301 (2006).
147 *United Distribution*, 88 F.3d at 1123 (*citing* Richard J. Pierce, Jr., *Reconstituting the Natural Gas Industry from Wellhead to Burnertip*, 9 Energy L.J. 1, 11-16 (1988)).
148 *Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol*, FERC Stats. & Regs. 30,665 (1985).
149 *United Distribution*, 88 F.3d at 1123.

"take or pay" contracts.[150] According to the Court, FERC's new requirements coupled with the "take or pay" contracts actually may "bring about a wasteful imbalance between pipeline sales and unbundled transportation service."[151] Therefore, the Court remanded the matter for the FERC to consider that issue.[152]

Thereafter, FERC issued another Order that effectively completed the transition to a competitive market for the natural gas pipeline industry, Order No. 636.[153] In that Order, FERC created mandatory unbundling of pipelines' sales and transportation services.[154] The D.C. Circuit upheld most of Order No. 636 while remanding certain aspects of the order.[155] The current competitive environment in the natural gas pipeline industry resulted.

Today, the natural gas pipeline industry is financially healthy. Although pipelines and local distribution companies are still regulated to some extent, natural gas producers and marketers are not directly regulated.[156] FERC's approach allows the market to determine prices and marketers, producers, LDCs, and even end-users to procure transportation on pipelines on an open and non-discriminatory basis.[157]

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[150] *Associated Gas Distrib. v. FERC*, 824 F.2d 981, 1044 (D.C. Cir. 1987)
[151] *Id.*
[152] *Id.*
[153] Restructuring of Pipeline Services, Order No. 636, FERC Stats. & Regs. 30,939, at 30,393, *order on reh'g*, Order No. 636-A, FERC Stats. & Regs. 30,950, *order on reh'g*, Order No. 636-B, 61 FERC 61,272 (1992), *order on reh'g*, 62 FERC 61,007 (1993), *aff'd in part and remanded in part sub nom. United Distribution Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *order on remand*, Order No. 636-C, 78 FERC 61,186 (1997).
[154] *United Distribution*, 88 F.3d at 1126.
[155] *Id.* at 1191.
[156] *See* NaturalGas.org, The Market Under Regulation, http://www.naturalgas.org/regulation/market.asp (last visited April 11, 2011).
[157] *Id.*

VII. DEREGULATION IN THE TELECOMMUNICATIONS INDUSTRY SHOWS THAT TRUE DEREGULATION WITH ACCESS AND COMPETITIVE INTERCONNECTION LEADS TO ROBUST COMPETITION AND A THRIVING INDUSTRY

The telecommunications industry provides a prime example of how an appropriate regulatory framework can facilitate robust competition and investment. For years, federal law has required local telephone companies to provide long distance companies with reasonable access to their local telephone networks and, therefore, provide customers with the option to choose among competing long distances companies. Under this regime, the long distance company pays the local telephone company an access charge for the origination or termination of the long distance telephone call in accordance with rate standards established by the Federal Communications Commission ("FCC") or state commissions.[158]

Competition in the market for long distance telephone service can be traced back to two pivotal cases decided by Judge Harold Greene of the United States District Court for the District of Columbia – the divestiture of AT&T and the acquisition of Sprint by GTE. Just as the Staggers Rail Act envisioned a world in which competition would function to set railroad rates, Judge Greene prophetically explained in 1984 that these cases were part of a transformation of the telecommunications industry from one "dominated by a monopoly enterprise to one in which competition determines prices, quality, growth, and innovation."[159] He also explained that the decrees entered into in these cases had a common purpose "to prevent the defendant companies

[158] *Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers, High-Cost Universal Service Support; Developing an Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up*, Notice of Proposed Rulemaking and Further Notice of Proposed Rulemaking, FCC 11-13 at 47-48, n.33 (Feb 9, 2011); Unified Intercarrier Compensation, 76 Fed. Reg. 11,632 (Mar. 2, 2011).
[159] *United States v. GTE Corp.*, 603 F. Supp. 730, 752 (D.D.C. 1984).

from impeding competition, by the use of local telecommunications monopoly bottlenecks, in markets where such competition is technologically feasible."[160]

More specifically, in 1982, as part of the AT&T case, Judge Greene approved a Modification of Final Judgment ("MFJ") that required the reorganization of AT&T.[161] Under this reorganization, among other things, the company's local telephone service and long distance service were separated. The resulting local telephone companies were called Bell Operating Companies and the long distance service remained under AT&T.

The MFJ required the regional Operating Companies to provide long distance companies equal access to their networks and not to discriminate between AT&T and its affiliates and their products and services and other persons and their products and services. More specifically, the Operating Companies were required to provide long distance carriers (also referred to as interexchange carriers) access to the local network "on an unbundled, tariff basis, that is equal in type, quality, and price to that provided to AT&T and its affiliates."[162] The MFJ also required that the charges accessed to the long distance companies be "cost justified."[163]

Two years later in 1984, Judge Green approved similar requirements in an antitrust case against GTE. In this case, the United States government challenged GTE, which provided local telephone service, when it tried to purchase the telecommunications enterprises of a company that operated Sprint long distance services. The court eventually approved the merger and the adoption of equal access and non-discrimination requirements. The court explained that these provisions "are likely to extend a significant benefit both to the public and to GTE's competitors,

[160] *Id.*
[161] *United States v. AT&T*, 552 F. Supp. 131, 226-234 (D.D.C. 1982) *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983).
[162] *Id.* at 227.
[163] *Id.* at 227, 233.

and they represent a significant step forward toward the creation of a more competitive environment in the telecommunications industry."[164]

This regulatory regime developed further over time. For example, the FCC established regulations governing access charges under Part 69 of its rules, and applied equal access principles to additional local telephone carriers.[165]

The Telecommunications Act of 1996 ("Telecom Act") further transformed the industry and ensured that local Operating Companies would not be permitted to engage in monopolization to thwart competition in long distance service.[166] In addition to carrying forward the same equal access and non-discriminatory interconnection restrictions and obligations already in place, the Telecom Act established a general requirement that telecommunications carriers interconnect with each other and facilitated the establishment of competitive local telephone companies that would provide service in the same area as, and compete with, the incumbent service provider.[167] For example, the Telecom Act provided for the unbundling of certain elements of the incumbent carrier's network for use by a competitive company, reciprocal compensation for the transmission of traffic between local telephone networks, and the resale of an incumbent's telecommunications service by a competitor.

As a result of these statutory and regulatory efforts, the telecommunications industry has blossomed, customers have access to a wide range of competing carriers and service options, and there is robust investment in current and future technologies. Although the access and interconnection requirements took a modest amount of effort on the part of the agency and

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[164] *GTE Corp.*, 603 F. Supp. at 730, 739, 743.
[165] *See* 47 C.F.R. Part 69; *MTS and WATS Market Structure Phase III: Establishment of Physical Connections and Through Routes among Carriers; Establishment of Physical Connections by Carriers with Non-Carrier Communications Facilities; Planning among Carriers for Provision of Interconnected Services, and in Connection with National Defense and Emergency Communications Services; and Regulations for and in Connection with the Foregoing*, Report and Order, 100 FCC.2d 860, 861 (1985).
[166] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 (1996).
[167] *See generally* 47 U.S.C. §§ 251, 252; *see also, id.*, § 251(g).

industry to flesh out, once standards were settled, their implementation has for the most part become routine.

VIII. CONCLUSIONS AND RECOMMENDATIONS

The Interested Parties believe that the Board should comprehensively review its competition rules and precedents, and initiate in the near future proceedings to revise those rules and precedents. These Interested Parties believe that the Board should initiate action in at least the following areas.

The Board should take immediate steps to revoke its Ex Parte No. 445 (Sub-No. 1) *Intramodal Rail Competition* rules, including its determination that the agency will only step in to prescribe reciprocal switching arrangements where necessary to remedy or prevent acts that are "contrary to the competition policies" of 49 U.S.C. § 10101 or are "otherwise anticompetitive." At the same time, the Board should declare that the STB shall not follow its precedent in *Midtec Paper Corp. v. Chicago and North Western Transportation Company*, 3 I.C.C.2d 171 (1986), *aff'd*, *Midtec Paper Corp. v. United States*, 857 F.2d 1487 (D.C. Cir. 1988); *Vista Chemical Company v. Atchison, Topeka and Santa Fe Ry.*, 5 I.C.C.2d 331 (1989); *Shenango, Inc. v. Pittsburgh, C & Y Ry.*, 5 I.C.C.2d 995 (1989), *aff'd sub nom. Shenango, Inc. v. ICC*, 904 F.2d 696 (3d Cir. 1990); and, *Golden Cat Division of Ralston Purina Company v. St. Louis Southwestern Railway Company*, ICC Docket No. 41550 (served Apr. 25, 1996), with respect to the establishments of reciprocal switching under 49 U.S.C. § 11102(c). Finally, the Board should also implement changes to its rules on reciprocal switching and terminal access, in order to encourage the use of such actions for the purpose of facilitating and encouraging rail-to-rail competition.

The Board should initiate a proceeding to declare that the STB shall not follow its precedent in *Central Power & Light Co. v. Southern Pacific Transportation Company*, 1 S.T.B. 1059 (1996), *aff'd sub nom. MidAmerican Energy Company v. Surface Transportation Board*, 169 F.3d 1099 (8th Cir. 1999), and will entertain future requests for bottleneck rates. Moreover, the Board should declare that it no longer will presume that the presence of two railroad service between an origin and destination shall constitute effective competition.

Alternatively, or in addition to the above, the Board should consider whether it should exercise its continuing jurisdiction pursuant to 49 U.S.C. § 11327 to reopen prior merger proceedings for the limited purpose of supplementing those approvals with additional pro-competitive conditions. These conditions might include: (1) requirements that each railroad quote, upon request, a single-line rate applicable from any origin or interchange point served by it to any destination or interchange point served by it without restricting in any way the application of such a single-line rate in combination with other rail rates; (2) prohibitions against any railroad from discussing, agreeing upon, or sharing information with respect to any single-line rate with any person, including any other railroad or railroad agency or association, other than the shipper involved in that specific single-line movement; and (3) prohibitions against any discussions between or among railroads regarding rates other than those individual rate discussions regarding joint line rates between or among participating interline partners.

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April 12, 2011

Exhibit A
Statements of Interest

Alliance For Rail Competition

The Alliance for Rail Competition (ARC) is a non-profit trade association that represents rail shippers who have limited or no access to rail-to-rail competition. Members include coal, utilities, agriculture, consumer and industrial products, minerals and petrochemical industries, various manufacturers and some chemical interests. Members of ARC contribute work efforts and financially to the organization which represents their interests to generate and educate interests who affect railroad regulatory policy. ARC members consist of people who have interface with the railroads and bear the freight bill in the market place. Issues in this proceeding are shared by all ARC members.

The American Chemistry Council

The American Chemistry Council represents the leading companies in the business of chemistry. ACC's 145 member companies apply the science of chemistry to provide innovative products and services that make people's lives better, healthier, and safer. ACC is committed to improved environmental, health, and safety performance through Responsible Care®, to common sense advocacy designed to address major public policy issues, and to health and environmental research and product testing. The business of chemistry is a $674 billion per year enterprise, a key element of the nation's economy, and the nation's largest exporting sector (chemicals account for 10 cents out of every dollar of U.S. exports). ACC members manufacture a wide array of products and depend on the railroads for the safe, efficient, and secure transportation of more than 160 million tons of chemical products each year.

American Forest and Paper Association

AF&PA is the national trade association of the forest products industry, representing pulp, paper, packaging, and wood products manufactures and forest landowners. The forest products industry relies on railroads for the transportation of raw materials to its mills for bringing finished products to the marketplace.

American Public Power Association

APPA is the national service organization representing the interests of over 2,000 municipal and other state and locally owned electric utilities in 49 states (all but Hawaii). Collectively, public power utilities deliver electricity to one of every seven electric consumers (approximately 46 million people), serving some of the nation's largest cities. Over 40% of public power utilities generate power from coal and many of these utilities are captive to a single railroad.

The Chlorine Institute

The Chlorine Institute, Inc. (the "Institute") is a 200-member, not-for-profit trade association of chlor-alkali producers worldwide, as well as packagers, distributors, users, and suppliers. The Institute's mission is the promotion of safety and the protection of human health and the environment in the manufacture, distribution, and use of chlorine, sodium hydroxide, potassium hydroxide, and sodium hypochlorite, plus the distribution and use of hydrogen chloride. The Institute's North American Producer members account for more than 95 percent of the total chlorine production capacity of the U.S. and offer for transportation approximately 40 percent of the TIH materials moved by rail each year. Chlorine is an essential commodity upon which the Nation's health, safety, and economy depend. Chlorine is essential in the production of a staggering list of products used each day in modern life. Everyone knows about chlorine's use in water disinfection and sewage treatment, but chlorine is essential to the manufacture of automobiles, computers, telephones, fuel cells, pharmaceuticals, rocket propellants, surgical sutures, paint removers, photographic supplies, virtually every plastic material made, and literally thousands of other products. Chlorine and chlorine chemistry is indeed essential in our modern lives.

Colorado Wheat Administrative Committee

The Colorado Wheat Administrative Committee discloses is a state created Board that controls funding for education, research, and domestic and export promotion programs.

Consumers United for Rail Equity

CURE is an incorporated, non-profit, advocacy group with the single purpose of seeking rail policy favorable to rail-dependent shippers, many of which are referred to as captive rail customers or captive shippers. CURE is sustained financially by the annual dues and contributions of its members, who are individual rail-dependent rail customers and their trade associations. Included in CURE are electric utilities that generate electricity from coal, chemical companies, forest and paper companies, cement companies, agricultural entities, various manufacturers, and national associations, including both trade associations and associations of governmental institutions whose members work to protect consumers. The issues that are the subject of this proceeding potentially affect all CURE members.

Edison Electric Institute

EEI is the association of U.S. shareholder-owned electric utility companies. EEI's members serve 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and they represent approximately 70 percent of the U.S. electric power industry. EEI's membership includes utilities that operate coal-fired generating plants and transport coal via rail, often in situations where they are captive to a single railroad.

Glass Producers Transportation Council

The Glass Producers Transportation Council (GPTC) is a national trade association devoted to the transportation and logistics interests of the American glass industry. GPTC's membership includes most of the major U.S. producers of glass containers, automotive glass, fiber glass, architectural glass, specialty and pharmaceutical glass and tableware (as well as many other glass products) and their raw material suppliers of soda ash, sand, limestone and other materials.

Idaho Barley Commission

The Idaho Barley Commission is a self governing state agency that serves to enhance the. profitability of barley growers through research, market development, promotion,

information, and education.

Idaho Wheat Commission

The Idaho Wheat Commission is a quasi-state agency that promotes wheat market development, research, and education for the wheat industry.

Kansas Wheat Commission

Kansas Wheat Commission is a state funded check-off for wheat to promote research, marketing and education.

Large Public Power Council:

The Large Public Power Council (LPPC) is an association of 25 of the nation's largest locally owned, not-for-profit electric power systems. LPPC members provide reliable, affordable electricity to most of the more than 45 million customers in 11 states and Puerto Rico served by public power. Our members own and operate over 35,000 circuit miles of transmission lines and over 86,000 megawatts of generation, reflecting a balanced portfolio of renewable energy, fossil fuel, nuclear, hydropower, and other resources. As electricity generators, the LPPC members charge costs and rates that directly reflect the rail rates they are charged to move coal to their generating stations.

Montana Farmers Union

The Montana Farmers Union is a statewide grassroots organization working for family farmers, ranchers and rural communities through conferences, scholarships and other educational opportunities as well as legislative representation and support for producer-owned co-ops.

Montana Wheat & Barley Committee

The Montana Wheat and Barley Committee is a state funded check-off program for wheat and barley growers in Montana. It promotes research, marketing, and end-use to aid in the market development of wheat and barley grown in Montana.

National Association Of Wheat Growers

NAWG works with a team of 21 state wheat grower organizations to benefit the wheat industry at state and national levels. NAWG is a nonprofit partnership of U.S. wheat growers who, by combining their strengths, voices and ideas, are working to ensure a better future for themselves, their industry and the general public.

National Grain and Feed Association

NGFA, established in 1896, is a U.S.-based nonprofit trade association that consists of more than 1,000 companies in the United States, Canada, and Mexico involved in all aspects of grain merchandising, processing, storage, transportation, feed manufacturing, integrated livestock operations, exporting, and importing grain and grain products. NGFA-member companies comprise over 6,000 facilities that handle more than 70 percent of U.S. grains and oilseeds. NGFA members include small country elevators, as well as the largest firms in the industry, most with access to only a single rail carrier at each of their rail-served facilities. Affiliated with NGFA are 35 state and regional grain and feed trade associations.

The National Industrial Transportation League

The League is one of the oldest and largest national associations representing companies engaged in the transportation of goods in both domestic and international commerce. The League was founded in 1907, and currently has over 600 company members. These company members range from some of the largest users of the nation's and the world's transportation systems, to smaller companies engaged in the shipment and receipt of goods. The majority of the League's members include shippers and receivers of goods; however, third party intermediaries, logistics companies, and other entities engaged in the transportation of goods are also members of the League. The League's rail shippers are from a multitude of industries, including chemicals/petroleum, agricultural, forest products and paper, and steel, among others. Thus, the League has a very substantial interest in the issues presented by this proceeding.

National Rural Electric Cooperative Association:

NRECA is the national service organization for more than 900 not-for-profit rural electric utilities that provide electric energy to approximately 42 million consumers in 47 states or 12 percent of the nation's population. Kilowatt-hour sales by rural electric cooperatives account for approximately 11 percent of all electric energy sold in the United States. NRECA members generate approximately 50 percent of the electric energy they sell and purchase the remaining 50 percent from non-NRECA members. The vast majority of NRECA members are not-for profit, consumer-owned cooperatives. NRECA's members also include approximately 66 generation and transmission ("G&T") cooperatives, which generate and transmit power to 668 of the 846 distribution cooperatives. The G&Ts are owned by the distribution cooperatives they serve. Remaining distribution cooperatives receive power directly from other generation sources within the electric utility sector. Both distribution and G&T cooperatives were formed to provide reliable electric service to their owner-members at the lowest reasonable cost.

<u>Nebraska Wheat Board</u>

Nebraska Wheat Board is established by the state of Nebraska is a state agency that levies taxes on wheat marketed in Nebraska and uses tax funds to further national and international wheat market development, policy development, research, promotion, and education.

<u>Oklahoma Wheat Commission</u>

The Oklahoma Wheat Commission is a state created trade association that promotes the interest of Hard Red Winter wheat.

<u>Portland Cement Association:</u>

Portland cement is a manufactured powder that acts as the glue or bonding agent that forms concrete. As an essential construction material and a basic component of our nation's infrastructure, portland cement is utilized in numerous markets, including the construction of highways, streets, bridges, airports, mass transit systems, commercial and residential buildings, dams, and water resource systems and facilities. The low cost and universal availability of portland cement ensures that concrete remains one of our nation's most essential and widely used construction materials. Portland Cement Association (PCA) represents 25 cement companies, operating 97 manufacturing plants in 36 states, with distribution centers in all 50 states. PCA members account for 97.1 percent of domestic cement production capacity.

South Dakota Wheat Commission

The South Dakota Wheat Commission is established by the state of South Dakota for the stabilization and profitability of South Dakota wheat industry through research, market development, and promotion.

Texas Wheat Producers Board

The Texas Wheat Producers Board was created by Texas state commodity referendum law to oversee the collection and expenditure of check off dollars in the wheat industry. It seeks to promote research, market development and promotion.

The Fertilizer Institute

TFI is the national trade association of the fertilizer industry. TFI, which traces its roots back to 1883, represents virtually every primary plant food producer, as well as secondary and micronutrient manufacturers, fertilizer distributors and retail dealerships, equipment suppliers and engineering construction firms, brokers and traders, and a wide variety of other companies and individuals involved in agriculture. Many members of TFI rely heavily upon rail transportation. They have witnessed the changing state of competition in the rail industry and experienced its effects first-hand. As such, they are well-positioned to describe both the changes and impacts to the Board, and to suggest ways to facilitate greater competition.

U.S. Clay Producers Traffic Association

The U.S. Clay Producers Traffic Association, Inc. ("Clay Producers" or "Association") is a non-profit association of member companies engaged in producing and shipping clay in all modes of transportation from Georgia, South Carolina, and Tennessee origins to numerous industries throughout the United States, Canada, Mexico, and the world. The Association was formed over 50 years ago to provide information to members concerning the transportation of clay, and also as a forum for discussion of developments and information concerning regulation by governing authorities affecting the transportation of clay. The Association has also historically represented the interests of its members in transportation matters before regulatory agencies, such as this Board.

Washington Grain Commission

The Washington Grain Commission is a state agency created by wheat producers to conduct market development and expansion for Washington-produced wheat and barley; research development and enhancement of production and marketing; public relations; monitor transportation issues affecting the movement of wheat and barley; and investigate and take action to prevent unfair trading practices.

Exhibit B

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

OFFICE OF OVERSIGHT AND INVESTIGATIONS
MAJORITY STAFF

THE CURRENT FINANCIAL STATE OF THE CLASS I FREIGHT RAIL INDUSTRY

Staff Report for Chairman Rockefeller
September 15, 2010

Executive Summary

Thirty years ago, Congress made sweeping changes to the laws regulating freight railroads to give the industry the opportunity to improve its finances and its ability to compete against other transportation modes. The Staggers Rail Act of 1980 allowed freight railroads to get rid of unprofitable lines and to consolidate their operations. The law also allowed the railroads to charge lower rates to their customers who operated in a competitive environment, and higher rates to customers who were "captive" to one railroad carrier for transportation service.

A review of the Class I railroads' recent financial results shows that the Staggers Act's goal of restoring financial stability to the U.S. rail system has been achieved. The restructuring of the industry that the Staggers Act set into motion thirty years ago has produced a so-called "rail renaissance." The four Class I railroads that today dominate the U.S. rail shipping market are achieving returns on revenue and operating ratios that rank them among the most profitable businesses in the U.S. economy.

After struggling with declining market share and rates in the years after the Staggers Act became law, the railroads have now regained their pricing power and begun increasing railroads' share of the freight transportation market. Unlike other transportation modes such as trucking, the railroads have been able to maintain their high profit margins even during the sustained economic downturn of 2008-10. Freight railroads have been assuring their investors the companies will take advantage of this "robust pricing environment" and continue to push rate increases on their customers.

While the freight railroads have been investing record amounts of their profits into much-needed capital projects, they have also doubled dividend payments to their shareholders and spent billions more dollars repurchasing their publicly-traded shares to boost the short-term value of their stocks. These large expenditures undermine the railroads' argument that they still lack the income to invest in their long-term capital needs. In addition to their own capital investments, the railroads have recently received hundreds of millions of dollars from state governments and the federal government to support their network improvement activities.

The companies' strong financial performance has attracted billions of new investment dollars, including the unprecedented $34 billion dollar purchase of the BNSF railroad by Berkshire Hathaway, the operating company of the investor Warren Buffett. Buffett predicts that BNSF and the other large Class I railroads will show "steady and certain growth" over the coming decades.

In spite of the obvious financial strength of the Class I railroads, their industry association, the Association of American Railroads (AAR), continues to tell Congress and the Surface Transportation Board (STB) that the freight rail industry is not yet financially stable and is not yet capable of meeting its capital needs without the differential pricing powers the Staggers Act gave the railroads in 1980. As the rail industry continues to operate profitably and to aggressively exercise its pricing power, these claims need to be more carefully scrutinized.

I. Past Financial Problems in the Rail Industry

Faced with a national railroad system in financial decline and physical disrepair, Congress passed the Staggers Rail Act (Staggers Act) in 1980.[1] Citing the railroads' declining share of intercity freight transportation and the industry's poor financial performance, the authors of the Staggers Act said the purpose of the law was to provide "the opportunity for railroads to obtain adequate earnings to restore, maintain, and improve their physical facilities while achieving the financial stability of the national rail system."[2]

The law directed the Interstate Commerce Commission (and its successor, the Surface Transportation Board) to shift its regulatory focus from rate-making to the financial health of the railroad industry. Under this new approach, "the Commission is required to make efforts to ensure that rail carriers earn adequate revenues."[3] The Act legalized private transportation contracts, encouraged railroad mergers, and accelerated abandonment of unprofitable rail lines.

In order to increase the railroads' ability to earn "adequate revenues," the Staggers Act allowed railroads to charge higher rates to shippers over which they had "market dominance."[4] Because railroads could not build their fixed business costs into the rates they charged shippers who had access to competing transportation modes—such as trucks, barges, or other railroads—Congress allowed them to charge higher markups on so-called "captive" shippers without viable transportation alternatives. In order to increase the rail industry's revenues, the Act required regulators to accept as "reasonable" even rates with very high captive-shipper markups.[5] According to the authors of the Staggers Act, regulators would have greater authority to review this so-called "differential pricing" when the railroads were once again financially stable businesses.[6]

The pricing and regulatory reforms in the Staggers Act led to wide-ranging changes in the railroad industry. In 1980, there were 39 Class I railroads, employing 458,000 workers, and

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[1] Staggers Rail Act of 1980, Pub. L. No. 96-448.

[2] U.S. House of Representatives, *Staggers Rail Act of 1980 Conference Report*, 96th Cong. (H.R. Rep. No. 96-1430) at 80.

[3] *Id.* at 89.

[4] *Id.* at 90-91; 49 U.S.C. § 10707.

[5] A captive shipper is not entitled to STB review of the reasonableness of a rate unless it can demonstrate that the rate produces revenues above 180% of the railroad's "variable costs" in providing the service, and that is has no other transportation alternatives. 49 U.S.C. § 10707. In the railroad industry, "variable costs" are the expenses a railroad carrier incurs in the course of a particular shipment of goods, while "fixed costs" (also known as "joint and common costs") are the expenses railroads incur to maintain their networks, but are not attributable to specific customers or shipments.

[6] *Staggers Rail Act of 1980 Conference Report*, *supra* note 2, at 91. ("The Conferees have adopted the concept of a jurisdictional level that varies according to the performance of the railroad industry. When the industry is earning revenues which are adequate, it is appropriate for the Commission to have the authority to review rate increases more carefully.").

owning 270,623 miles of track.[7] Thanks to a wave of mergers and consolidation in the 1980s and 1990s, today there are only seven Class I railroads. In 2008, these companies employed 164,000 workers and owned 160,734 miles of track.[8] In spite of the fact that the Class I railroads own significantly less track and employ fewer workers than they did in 1980, their network handled almost twice as much cargo in 2008 (1.7 trillion revenue ton-miles) than it did in 1980 (918 billion revenue ton-miles).[9]

Also unlike 1980, today four Class I railroads dominate the long-haul freight market and function as "regional duopolies" in the eastern and western United States.[10] Burlington Northern Santa Fe (BNSF) and Union Pacific dominate freight rail transportation west of the Mississippi, and CSX and Norfolk Southern dominate the business east of the Mississippi. In 2008, these four railroads accounted for over 90% of Class I freight shipments and over 92% of Class I railroads' $61 billion in revenues.[11]

II. Current Financial Picture

In their official communications with the Surface Transportation Board (STB), freight railroad carriers consistently tell their regulators that while their industry's financial condition has significantly improved since 1980, they have not yet reached the "financial stability" goal established in the Staggers Act. In 2007, for example, the Association of American Railroads (AAR), the rail industry's trade group, told the STB that since the passage of the Staggers Act, Class I railroads have "only slowly made progress toward the goal of long-term financial sustainability."[12] While "freight railroads are finally showing tangible signs that financial sustainability might be within reach," the AAR concluded, the companies have not yet reached that point.[13]

A year later, in April 2008, AAR told the STB in written testimony that the railroads' profitability was "still far from stellar in comparison to the many other industries against which

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[7] Association of American Railroads, *Railroad Facts, 2009 Edition* (2009).

[8] *Id.*

[9] *Id.* Railroads measure the total amount of freight they ship using the measure "revenue ton miles," which is the weight of paid tonnage multiplied by the total number of miles the freight has been transported.

[10] Wolfe Research, *A Training Manual. Will Rail Renaissance Survive Recession and Re-Regulation?* (May 2009), at 10. (hereinafter "Wolfe, Training Manual")

[11] Association of American Railroads, *Railroad Ten-Year Trends, 1999-2008* (Feb. 2010).

[12] Comments of the Association of American Railroads, *STB Ex Parte No. 671, Rail Capacity and Infrastructure Requirements* (April 4, 2007). The STB filings that are cited in this report can be obtained by searching the STB's online database by docket number at http://www.stb.dot.gov/home.nsf/EnhancedSearch?OpenForm&Type=F.

[13] *Id.*

railroads compete for capital" and that "rail industry profitability has consistently lagged most other industries – and that is still the case today."[14]

While the rail industry's regulatory filings with the STB portray an industry that is still struggling to attract capital and to compete with the other transportation modes, the railroads' public financial results tell a different story. According to the four largest rail companies' Securities and Exchange Commission (SEC) filings, in recent years, these companies have far exceeded the Staggers Act's goal of bringing the railroads back from the brink of ruin to financial sustainability. In fact, today, the large U.S. rail companies are some of the most profitable publicly-traded companies in the world.

Policy makers, outside analysts, and the railroads themselves agree that today's industry bears little resemblance to the financially failing, inefficient rail industry of 1980. In 2007, the U.S. Department of Transportation told the STB that the Staggers Act has been "profoundly successful," noting that the railroads are financially healthy, the industry's infrastructure has been modernized, productivity is high, and shippers have benefitted from lower average rates.[15] According to BNSF's CEO, Matthew Rose, after Staggers passed in 1980, the railroads spent two decades going on a "productivity binge, wringing out excess costs, getting rid of inefficient lines, finding wage rates that we all could live within, both for employees and our companies." He told *USA Today*, "we think we are a very productive institution at this time."[16]

As a result of these changes, as well as increases in highway congestion and fuel costs, the railroad industry is no longer at a competitive disadvantage to other transportation modes, as it was when the Staggers Act was passed in 1980. According to a financial analyst at BB&T Capital Markets, four years ago, trucks handled 80% of the freight hauls between 700 and 1,000 miles, while today trucks and railroads split this market.[17] A well-respected transportation analyst, Wolfe Research, predicts that railroads will "likely continue to take market share from the less fuel-efficient and increasingly less productive truck industry."[18]

A review of the largest four railroads' Securities and Exchange Commission (SEC) filings shows just how profitable the large rail companies have become over the last decade. Figure I demonstrates that the four largest U.S. rail carriers have nearly doubled their collective profit margin in the last ten years to 13%.[19] In fact, in 2008, the railroad companies' 12.6%

[14] Written Testimony of the Association of American Railroads, *STB Ex Parte No. 677, Common Carrier Obligation of Railroads* (April 17, 2008).

[15] Written testimony of Jeffrey N. Shane, Under Secretary for Policy, Department of Transportation, *STB Ex Parte No. 671, Rail Capacity and Infrastructure Requirements* (April 4, 2007).

[16] *Warren Buffett sees strong rail system as key to U.S. growth*, USA Today (Mar. 25, 2010).

[17] *Burned Before, Railroads Take Risks*, Wall Street Journal (June 28, 2010).

[18] Wolfe, Training Manual at 6.

[19] The accounting measure used to measure profitability in this report is "profit margin" or "return on revenue," which is the percentage of a company's revenues that is net income. AAR and other industry representatives sometimes selectively use another financial ratio, the "return on shareholders' equity," to argue that the railroad industry's profits are modest compared to other sectors. Return on equity measures

profit margin placed the industry fifth out of 53 industries on *Fortune*'s list of "most profitable industries," trailing only the communications, Internet, pharmaceutical, and medical device industries.[20] Between 2001 and 2008, the railroad industry was ranked in the top ten on *Fortune*'s profitability list seven out of eight times. While the railroads were telling their regulators that their profitability trailed most other U.S. companies, they were actually among the U.S. economy's top performers.

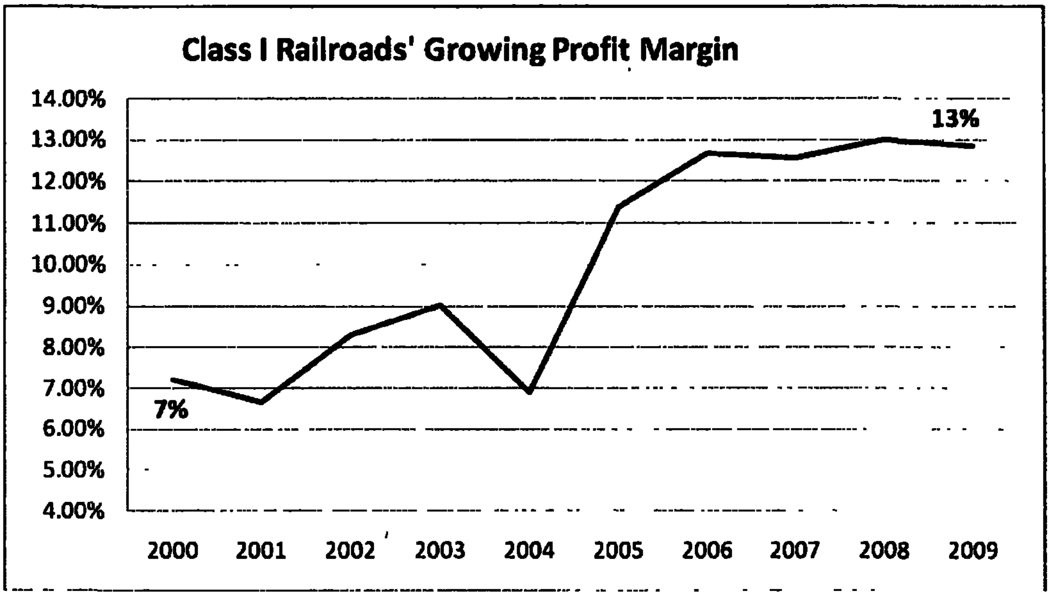

Figure 1 – Combined Profit Margins (Net Income/Revenue) for BNSF, Union Pacific, CSX, and Norfolk Southern, 2000-09 (Source: SEC filings)

III. Investor Interest in the Freight Railroad Industry

The companies' SEC filings over the past decade do not show that the railroad industry is "lagging behind" other industries, as AAR told its regulators in 2008. In fact, the railroads' growth in earnings and profitability has outpaced almost all of the other large industries it competes with for capital in the equity markets. Over the last decade, the large railroad companies have reported higher revenues and stable or only slowly-growing expenses, even during the recent economic recession. This relationship between operating expenses and

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not all net income, but only the income a company retains from year to year for future growth. Return on equity can be negatively affected by paying dividends or buying back stock. The Class I railroads' recent stock buyback activities are discussed in Section V of this report.

[20] Fortune, *2008's Top Industries: Most Profitable, Return on Revenues* (online at http://money.cnn.com/magazines/fortune/fortune500/2009/performers/industries/profits/) (accessed Aug. 27, 2010).

revenues is known as the "operating ratio," and is an important indicator of financial performance in many transportation sectors, including the rail and trucking industries.[21]

As Figure II demonstrates, railroads have been steadily lowering their operating ratios over the past decade, reaching a ten-year low in 2009. This 2009 result is especially impressive, since it was achieved in the midst of a severe economic downturn.

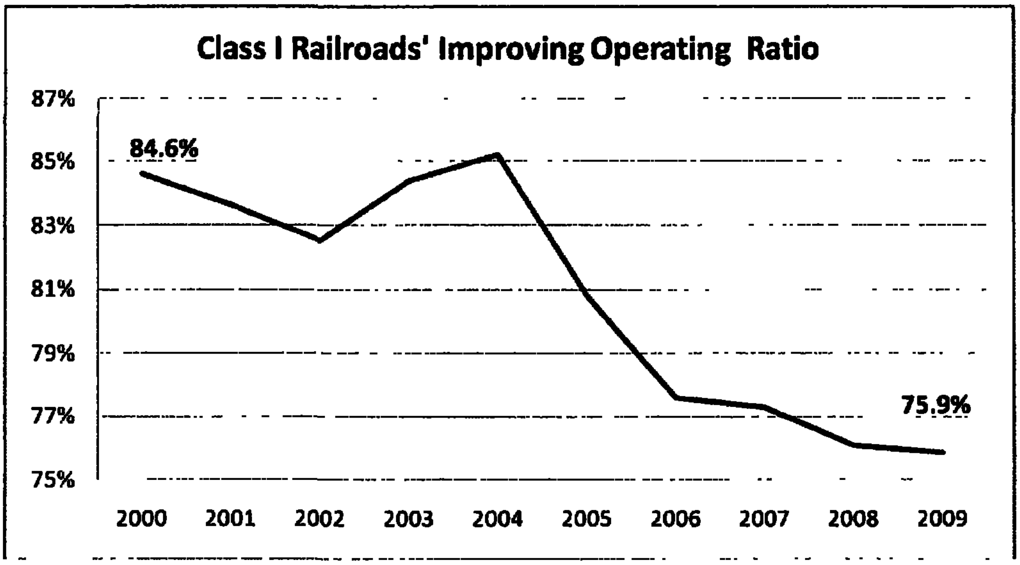

Figure II – Combined Operating Ratios (Expenses/Revenues) for BNSF, Union Pacific, CSX, and Norfolk Southern, 2000-09 (Source: SEC filings)

As the railroad industry's profit margins have risen and their operating ratios have dropped, investors have taken notice. As Figure III shows, the stock value of the four largest rail carriers over the past ten years has far exceeded the average stock value of the large U.S. companies that are part of the S&P 500. An index of large railroad company stocks monitored by Wolfe Research appreciated 119% between 2003 and 2009; the S&P index was down 0.3% during the same period.[22] Recent quantitative stock reports published by Standard & Poor's give quality rankings of "A", "A-", and "B+" to Union Pacific, Norfolk Southern, and CSX, respectively. Union Pacific and Norfolk Southern scored above the 90th percentile on S&P's

[21] *See e.g.*, Testimony of Michael J. Ward, Chairman and CEO, CSX Corporation, U.S. House Committee on Transportation and Infrastructure, Subcommittee on Railroads, Pipelines, and Hazardous Materials, *Hearing on Investment in the Rail Industry*, 110th Congress (March 5, 2008) (H. Rept. 110-104). ("Operating ratio, which is inverse margin or the ratio of operating expenses to operating revenues expressed as a percentage, is a widely used performance measurement in the railroad industry.")

[22] Wolfe, Training Manual at 6.

"Investability Quotient," a measure of an investment's desirability, while CSX received a score of 89%.[23]

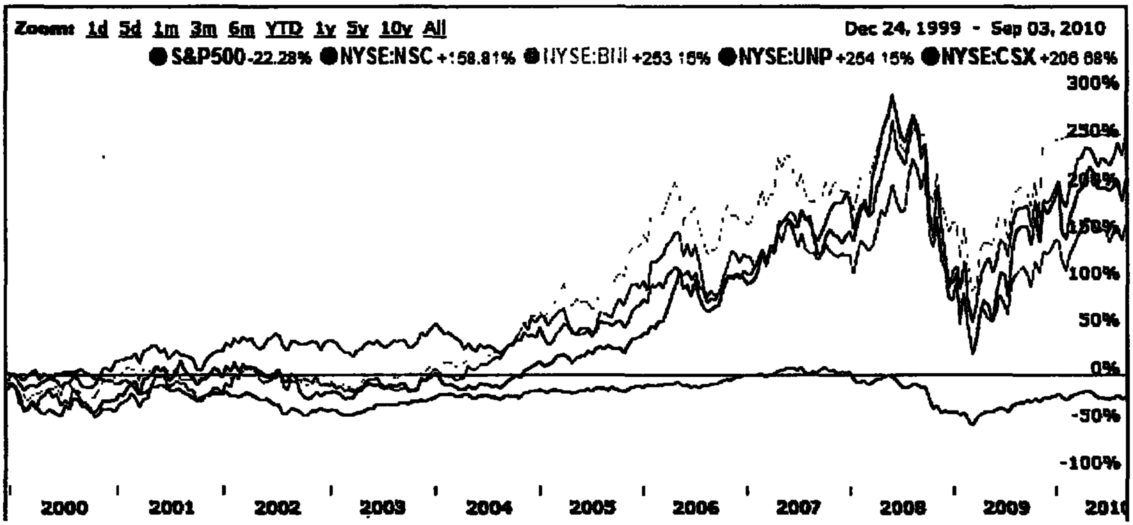

Figure III – Stock Performance of BNSF, Union Pacific, CSX, and Norfolk Southern Compared to the S&P 500 Index, 2000-09 (Source: Google Finance)

In November 2009, the investor Warren Buffett expressed his great confidence in the financial sustainability of the railroad industry by announcing that his company, Berkshire Hathaway, would purchase the 77.4% of the BNSF railroad his company did not already own. The deal was valued at approximately $34 billion, making it the largest ever acquisition in Berkshire Hathaway history.[24]

In discussing his acquisition of BNSF, Buffett said he believed his investment in BNSF would deliver "steady and certain growth" over the coming decades.[25] He also predicted that the U.S. rail industry has a "dynamic and profitable future" and that all four big freight railroads will "do very well" in the coming decades because they are the only mode of freight transportation that will be able to keep up with the American economy's increasing demand for consumer

[23] Standard & Poor's, Union Pacific, *Quantitative Stock Report* (Sep. 4, 2010); Standard & Poor's, Norfolk Southern, *Quantitative Stock Report* (Sep. 4, 2010); Standard & Poor's, CSX, *Quantitative Stock Report* (Sep. 4, 2010). Since its purchase by Berkshire Hathaway (see below), BNSF shares are no longer listed on the New York Stock Exchange.

[24] Burlington Northern Santa Fe Corporation and Berkshire Hathaway, Inc. Joint Press Release, *Berkshire Hathaway Inc. to Acquire Burlington Northern Santa Fe Corporation (BNSF) for $100 Per Share in Cash and Stock* (Nov. 3, 2009).

[25] *Buffett: Railroad business is 'in tune with the future'*, USA Today (Nov. 4, 2009).

goods and raw materials.[26] Analysts suggest that as much as $18 billion poured into the rail industry in the wake of Mr. Buffett's BNSF announcement.[27]

In his annual letter to Berkshire shareholders, Mr. Buffett noted the similarities between the capital-intensive railroad industry and the regulated electric utilities his company already owned. Like electric utilities, railroads "provide fundamental services that are, and will remain, essential to the economic well-being of our customers, the communities we serve, and indeed the nation." He predicted that Berkshire's investment in BNSF would "deliver significantly increased earnings over time, albeit at the cost of our investing many tens – yes, tens – of billions of dollars of incremental equity capital." [28]

IV. Railroad Industry Pricing Power

The railroad industry correctly points out that after the Staggers Act gave the railroads the ability to negotiate prices with shippers, railroad rates dropped significantly. According to the AAR, after adjusting for inflation, rail rates are still lower than they were in 1980.[29] The railroads' presumed inability to raise rates on freight shippers with competitive alternatives has long been the industry's justification for its differential pricing practices. Because they cannot adequately recover their costs from shippers with transportation alternatives, railroads are allowed to charge higher rates to "captive" shippers without alternatives.[30]

One of the recent structural changes that the railroad industry does not highlight is that since 2004, railroads have regained their ability to raise prices on their non-captive customers. One leading industry analyst, Wolfe Research, refers to this change as the industry's "pricing renaissance."[31] As Figure IV demonstrates, for a number of years after the Staggers Act was enacted, rail prices measured against inflation fell by an average of 3.6% a year. Since 2004, however, Class I railroads have been raising prices by an average of 5% a year above inflation.[32] And even during the recent recession, while other modes of freight transportation have cut their rates, the Class I railroads have been able to push year-over-year price increases onto their customers.[33]

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[26] *Warren Buffett sees strong rail system as key to U.S. growth*, USA Today (Mar. 25, 2010).

[27] *Id.*

[28] Berkshire Hathaway Letter to Shareholders (Feb. 26, 2010) (online at http://www.berkshirehathaway.com/letters/2009ltr.pdf).

[29] Association of American Railroads, *A Short History of U.S. Freight Railroads* (May 2010) (online at http://www.aar.org/incongress/~/media/aar/backgroundpapers/ashorthistoryofusfreightrailroads.ashx).

[30] Government Accountability Office, *Freight Railroads: Industry Health Has Improved, but Concerns about Competition and Capacity Should Be Addressed* (Oct. 2006) (GAO 07-94). See also the discussion in Section I above.

[31] Wolfe, Training Manual at 33.

[32] *Id.* at 35.

[33] *Id.* at 43.

This new "pricing power" has led to significant top-line revenue growth for Class I railroads and has resulted in the swelling profit margins described in the sections above. And according to Wolfe Research, because railroad rates are still below their inflation-adjusted 1980 levels, the freight rail carriers believe they will have a "solid multi-year glide path to continued strong rail pricing hikes regardless of the economic environment."[34] A recent Morgan Stanley analysis of the rail industry notes that in the current environment of strong railroad pricing power, "[r]ate negotiations continue to be difficult for shippers and competition remains minimal."[35]

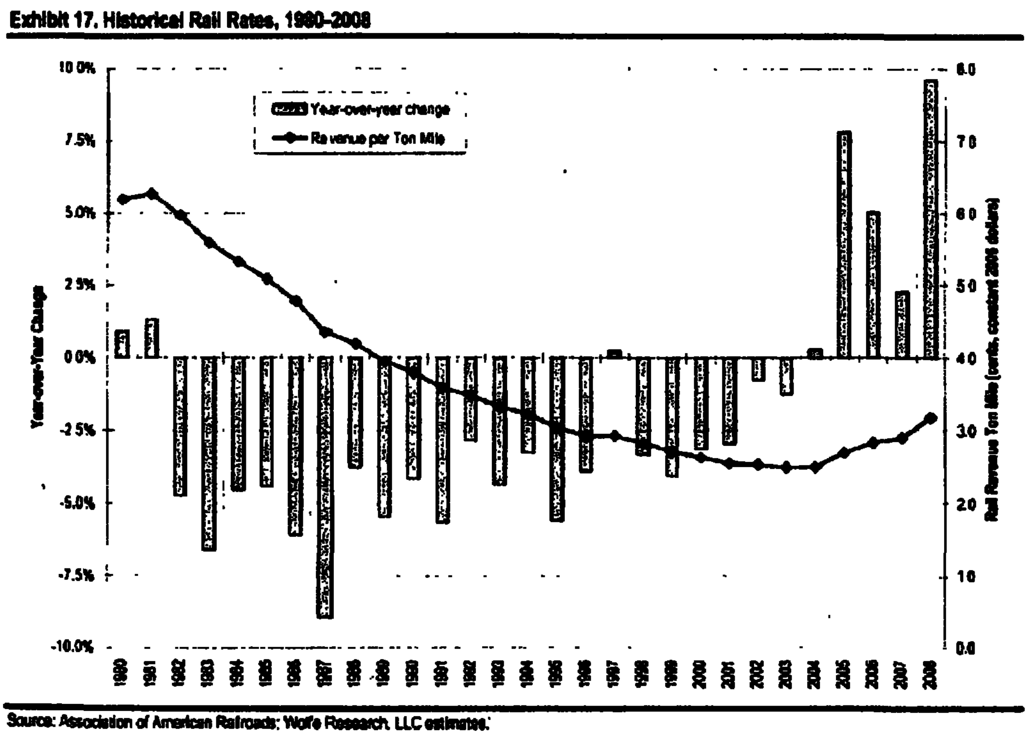

Figure IV- Annual Class I Rail Rates and Revenues, 1980-2008 (Source: Wolfe Research using Association of American Railroads Data)

In recent conversations with their investors, the rail companies have discussed this increase in pricing power and their expectation that it will continue in the future. In a recent investor call, Union Pacific's CEO, James Young, commented, "[t]he pricing environment is stronger today than it's been in a long time...I feel very good about the potential in the pricing

[34] *Id.* at 35.

[35] Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010).

side going forward."[36] A CSX senior executive, Clarence Gooden, made a similar prediction in his company's second-quarter 2010 investment call, when he said, "[l]ooking forward, we continue to expect core price increases to exceed rail inflation."[37]

A number of factors seem to lie behind the railroads' new "robust pricing environment."[38] Post-Staggers Act industry consolidation and capacity reduction slowly eliminated the excess supply of rails and rail service, while the railroads invested in making their remaining operations more productive. One industry analyst estimates that the railroads moved from a position of "material excess capacity" to "tight capacity" in the late 1990s or early 2000s and that the pendulum has continued to swing further in the industry's favor as demand for rail services continues to grow, particularly in the intermodal, coal, and grain markets.[39]

Another factor that has contributed to the industry's renewed pricing power over the past few years is its shift to short-term contracts with its customers. After the passage of the Staggers Act, during the time they had weak pricing power, the freight railroads entered into long-term contracts with many of their customers. As these so-called "legacy contracts" are expiring, railroads are replacing them with shorter-term contracts—sometimes for terms as short as one year—at significantly higher rates. Shippers also report that railroads are more frequently offering unilateral "take-it-or-leave-it" contracts to customers, a practice that bears more resemblance to setting a tariff rate than establishing a price through negotiation.[40]

Analysts view these expiring legacy contracts as an important source of pricing gains over the next few years. According to Wolfe Research, "[a]s these rail contracts are repriced over the next several years for the first time since the rails gained pricing power in 2004, we believe the rails will be recording material rate increases that could exceed 100% in some cases of very old and underpriced business. (e.g., ten-year old coal contracts)."[41] Morgan Stanley recently rated Union Pacific as its top Class I rail stock based on the fact that the company has the largest percentage of "revenue under legacy contract left to reprice."[42]

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[36] Union Pacific Corporation 2nd Quarter 2010 Earnings Conference Call (July 22, 2010).

[37] CSX Corporation 2nd Quarter 2010 Earnings Conference Call (July 13, 2010).

[38] Wolfe, Training Manual at 9.

[39] *Id.* at 34-35.

[40] These types of arrangements were the subject of a rulemaking by the STB that was discontinued because consensus on a new rule could not be reached. *See* STB Ex Parte No. 669 (*Interpretation of the Term "Contract" in 49 U.S.C. 10709*); STB Ex Parte 676 (*Rail Transportation Contracts Under 49 U.S.C. 10709*).

[41] Wolfe, Training Manual at 45.

[42] Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010).

V. Railroad Industry Capital Investments

Because they have the primary financial responsibility for their rail networks, Class I freight rail companies have both high fixed operating costs and constant needs for capital investments. In addition to the high costs of replacing and upgrading physical assets such as track, ties, and engines, major capital investments are required to expand the capacity of the rail network to address the growing demand for freight rail transportation in the United States.[43] While they tell Congress that they are still not producing sufficient revenue to address their long-term capital needs, a review of the railroads' financial filings and their statements to their investors suggests the opposite.

According to SEC reports filed by the four largest Class I railroads and summarized in Figure V, over the past ten years, the companies made a combined total of $62.5 billion in capital expenditures to replace and upgrade equipment and expand their rail networks. As the companies' revenues grew over the course of the decade, so did their capital investments. The four railroads spent $4.8 billion in 2000 on capital projects, while they spent $7.8 billion in 2009. While these capital investment figures are large, in their public relations materials, the freight railroad industry misleadingly makes them appear larger by adding maintenance costs to capital investments and calling the total "Spending on Infrastructure & Equipment."[44]

The railroad industry has consistently testified before Congress that while it has heavily invested in its network and will continue to do so, it will not be able to completely pay for all of the improvements necessary for freight railroads to meet the long-term capacity demands of the U.S. economy. These investments include upgrading tracks and signal control systems, expanding terminals, and improving bridges and tunnels. In testimony he delivered before the Senate Commerce Committee in 2009, for example, BNSF CEO, Matthew Rose, said that Class I railroads would fall short of paying for their long-term capital investments by approximately $40 billion.[45] A few months earlier, Union Pacific's CEO, James Young, told the House Transportation Committee that "our industry is only investing about half the level DOT studies say is needed to meet the demands on freight rail in the future."[46]

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[43] The industry is also working to lower its future capital needs by shifting some of its traditional costs to its customers, such as the cost of railcars. In 1987, railcars owned by freight railroad companies moved 60% of tons carried; by 2005, that figure had decreased to 40% of tons carried. Government Accountability Office, *Freight Railroads, supra*, note 30.

[44] *See e.g.*, Association of American Railroads, *Rail Earnings Today Pay for Rail Capacity and Service Improvements for Tomorrow* (May 2010) (online at http://www.aar.org/incongress/~/media/aar/backgroundpapers/railearningstodaypayforrailcapacityandserviceimprovementsfortomorrow.ashx).

[45] Testimony of Matthew K. Rose, Chairman, President and CEO, BNSF Railway Company, U.S. Senate Committee on Commerce Science, and Transportation, Subcommittee on Surface Transportation and Merchant Marine Infrastructure, Safety and Security, *Addressing Surface Transportation Needs in Rural America*, 111th Congress (Aug. 10, 2009) (S. Hrg. 111-490).

[46] Testimony of James R. Young, Chairman, President, and CEO, Union Pacific Corporation, U.S. House Committee on Transportation and Infrastructure, Subcommittee on Railroads, Pipelines, and Hazardous Materials, *Freight and Passenger Rail: Present and Future Roles, Performance, Benefits, and Needs*, 111th Congress (Jan. 28, 2009).

These statements are inconsistent with statements Class I railroad officials make about their capital investments to financial analysts in quarterly conference calls. In these calls, company officials routinely assure analysts their capital investments are sufficient to address future needs. In an investor call in late 2007, for example, the CEO of CSX, Michael Ward, told investors that his company was making the capital investments necessary "to prepare for future growth" and that the company would continue to "generate the cash flow to be able to make capital investment for the future." [47] In an investor call in April 2010, Mr. Young, the Union Pacific CEO, assured analysts that his company was "continuing to make the critical, long-term capital investments that support the Company's growth strategy."[48]

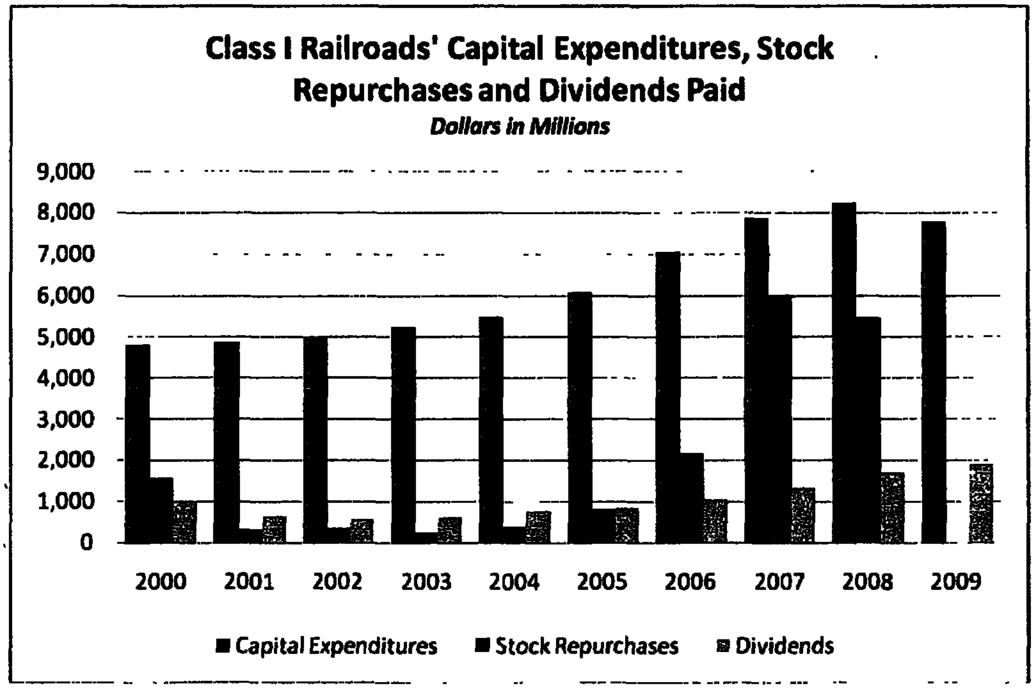

Figure V – Combined Capital Expenditures and Public Stock Repurchases of BNSF, Union Pacific, CSX, and Norfolk Southern – 2000-09 (Source: SEC filings)

Another indication that the Class I railroads believe they are spending sufficient amounts of money on their long-term capital needs is that in recent years, they have used growing portions of their net income to increase their dividend payments and to repurchase their publicly-traded shares. By reducing the number of shares on the market, buybacks have the effect of increasing earnings per share and driving up share prices. The capital expended to buy back shares provides short-term gains in stock value at the expense of investments that increase capacity and productivity. As Figure V shows, the four major U.S. railroads cumulatively spent

[47] CSX Corporation 3rd Quarter 2007 Earnings Conference Call (Oct. 17, 2007).

[48] Union Pacific 1st Quarter 2010 Earnings Conference Call (Apr. 22, 2010).

over $2 billion in share repurchases in 2006, over $6 billion in 2007, and over $5 billion in 2008. Although none of these companies repurchased shares in 2009, they have resumed their share buyback programs in 2010.[49] According to their most recent SEC quarterly filings, CSX, Norfolk Southern, and Union Pacific have already bought back more than $1.6 billion worth of shares in 2010.

Another factor that freight railroads do not highlight in their discussions of their long-term capital needs is that several high-profile railroad capacity projects recently have been financed through a combination of public and private funds. Railroads lobby Congress and state governments for taxpayer contributions to their rail infrastructure improvements and have had a few recent successes in establishing such "public-private partnerships."[50]

For example, public money funded almost 50% of Norfolk Southern's recently completed "Heartland Corridor" project.[51] That project enlarged 28 tunnels along an old coal route, creating a faster and more direct path for double-stack freight trains carrying intermodal freight between the international shipping port in Hampton Roads, Virginia, and Columbus, Ohio.[52] Similarly, Norfolk Southern's rival, CSX, is looking to the states and federal government to contribute more than 50% of the cost of its "National Gateway" project, which will also create a more efficient route for intermodal freight between the Mid-Atlantic ports and the Midwest. CSX has committed $395 million to this $842 million initiative and has received $98 million in federal funding and over $180 million from the states so far.[53]

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[49] *See, e.g.*, Morgan Stanley Research, North American Transportation, *Freight Transportation: Rails 2Q10 Review* (Aug. 6, 2010). ("Share repurchase activity is accelerating at a number of Class I's – a trend which is likely to add a few percentage points of EPS [earnings per share] growth annually to CNI, CSX, NSC, and UNP").

[50] *See, e.g.*, Testimony of Matthew K. Rose, Senate Committee on Commerce, Science, and Transportation, *Addressing Surface Transportation Needs in Rural America*, 111th Cong. (Aug. 10, 2009) ("As an industry, we're currently spending about $10 billion in the freight rail network. But, if policy leveraged those investments with public partnerships, these investments would happen more quickly, and with more certainty."); Testimony of James R. Young, House Committee on Transportation and Infrastructure, *Freight and Passenger Rail: Present and Future Roles, Performance, Benefits, and Needs*, 111th Cong. (Jan. 28, 2009) ("Congress should enact and fund programs that allow States to partner with freight railroads to move forward with projects that benefit both the freight railroad and the public.").

[51] Norfolk Southern put up $97.8 million for the project, the federal government added $83.3 million, and Ohio and Virginia provided $9.8 million. Associated Press, *Norfolk Southern Opens New $191 Million Route to Midwest* (Sept. 9, 2010).

[52] *Id.*

[53] *Railroads Redraw the Intermodal Map*, Journal of Commerce (Aug. 6, 2010).

Conclusion

Thirty years ago, in order to restore the financial stability of the U.S. rail network, Congress gave railroads the authority to charge captive shippers higher rates than other shippers. Today, the goal of restoring the financial health of the rail industry has been achieved. Class I freight railroads have regained the pricing power they lacked in the 1980s, and are now some of the most highly profitable businesses in the U.S. economy. The railroads have high levels of capital investment and consistently produce strong results for their shareholders throughout the economic cycle. As Congress and the federal government look to the nation's rail system to meet the United States' future transportation needs, they also need to evaluate whether our country's current rail policy needs to be changed to reflect this new reality.